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INDONESIA ECONOMIC QUARTERLY

Back on track?

December 2009

THE WORLD BANK | BANK DUNIA

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Investing in Indonesia's Institutions

for Inclusive and Sustainable Development

Preface

The Indonesian Economic Quarterly reports on and synthesizes the past three months' key developments in Indonesia's economy. It places them in a longer-term and global context, and assesses their implications for the outlook for Indonesia's economic and social welfare. Its coverage ranges from the macroeconomy to financial markets to indicators of human welfare and development. It is intended for a wide audience, including policy makers, business leaders, financial market participants, and the community of analysts and professionals engaged in Indonesia's evolving economy.

This *Indonesian Economic Quarterly* was prepared and compiled by the Poverty Reduction and Economic Management group's macroeconomic analysis team at the World Bank's Jakarta office. Shubham Chaudhuri, Senior Economist, led the team and edited this *Quarterly* with Tim Bulman, Economist. Contributions came from Andrew Blackman and Fitria Fitrani (external sector, trade flows and balance of payments), Andrew Carter (government revenues and balance), Andrew Ceber (national accounts and domestic demand), Diva Singh, Neni Lestari and Telisa Falianty (financial markets, monetary sector and banking indicators), Ahya Ihsan (government expenditures and balance) Tim Bulman (prices and government financing) and Matt Wei-Poi (poverty and labor market analysis). Magda Adriani and Fitria Fitrani provided data support to the team. Edgar Janz and Vivi Alatas prepared the feature on developments in Indonesia's labor market, Shubham Chaudhuri described Indonesia as a middle income country, and Claudia Rokx prepared the material for the feature on health financing. Dhauhari Sitorus, Nathan Dal Bon and P. S. Srinivas provided editorial suggestions. The full team is under the leadership of World Bank Jakarta Office Lead Economist William E. Wallace.

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Table of contents

LIST OF FIGURES

LIST OF TABLES

LIST OF BOXES

Executive Summary: Back on track?

Indonesia's economy seems back on track to faster growth and better standards of living, but risks remain

One year after the global financial crisis and economic downturn, Indonesia's economy appears to be broadly back on track. Economic activity has been picking up, inflation has remained moderate, financial markets have risen, and the newly reelected government, having established the strong fundamentals that supported Indonesia through the global crisis, appears to be now gearing up for new investments in Indonesia's physical infrastructure, human services and institutions of state. Indonesia seems well-positioned to get back on its pre-crisis growth trajectory, with the possibility of further acceleration and more inclusive growth. But this path is not inevitable and some questions remain. Significant risks remain in the global economy. The sustainability of the global recovery is still not entirely clear. And portfolio flows into emerging markets, which have surged in the last nine months, may as easily be reversed as policy makers elsewhere move to unwind the large monetary and fiscal stimulus efforts initiated over the last year. On the domestic front, political developments since October have begun to raise some questions about the timing and depth of future reforms.

Indonesia's economy continued to gradually strengthen into Q4, continuing the trends evident in September

Many of the trends in Indonesia's real economy evident at the time of the September *Quarterly* continued into the third and fourth quarters of 2009. Movements in Indonesia's real economy remained moderate. Indonesia has not experienced the sharp increases in growth in Q2 and Q3 2009 experienced by many of its neighbors, just as it was far less severely affected by the downturn around the turn of 2009. In Q3, Indonesia's growth continued to gradually accelerate, and the pick-up was broad based across both private and public demand and production sectors. Consumer indicators remained at the relatively high levels of mid year, while industrial activity sustained a measured recovery. Both export and import flows, which had fallen significantly with the crisis, continued to recover, supporting the ongoing current account surplus.

Against expectations, inflation, which was gaining momentum in the third quarter, became subdued in October and November. 2009 will be the lowest inflation year in almost a decade. At play in recent months were good domestic supply conditions and the appreciating rupiah limiting the growth of tradable prices, allowing many retailers to reverse their Ramadan- and Idul Fitri-related price rises. Nonetheless inflation expectations remain above the lows of early in the year and inflation is likely to pick up in coming months.

Financial markets have remained more volatile, with significant capital inflows supporting strengthening financial asset prices

While Indonesia's real economy remains remarkably stable, particularly relative to its neighbors', volatility in Indonesia's financial markets has continued. The rupiah continued to appreciate into early October, as significant inflows of non-resident funds continued into liquid financial assets – government bonds, short-term money market notes, and equities. These markets all strengthened through to late September or early October. From mid October, the inflows appear to have slowed and the prices of these financial assets, and of Indonesian government USD bonds, generally tracked sideways through to early December, with the rupiah settling into a range of 9,400 to 9,500 – only slightly weaker than before the onset of the crisis and stronger on a real effective exchange rate basis. Unlike elsewhere in the region, the rise in financial assets prices does not appear to be leading to higher prices for non-financial assets, such as urban property.

Other capital flows have generally returned to more 'normal' patterns, although foreign direct investment inflows have remained weak and Indonesian residents shifted more funds into offshore bank accounts in Q3 than is typical for periods when financial markets are rising. Reserves continued to rise, reaching USD 65.8 billion by late November.

The outlook remains for a gradual recovery in growth – and inflation, supporting a gradual improvement in poverty

The outlook remains for the economy to continue its gradual recovery. Growth in 2010 is likely to be around 5.6 per cent, rising to 6.0 per cent in 2011. Ongoing solid consumption growth and a recovery in machinery & equipment investment should support the economy. These projections assume that imports grow faster than exports given the expected stronger performance of Indonesia's economy compared to others and expected increase in investment, although this projection may be conservative given the relative resilience of Indonesia's exports since late 2008.

Inflation is projected to build again with the accelerating economy and projected gradual rise in commodity prices. But the rupiah's appreciation is expected to slow the rise in inflation in the first part of 2010. Energy pricing reform presents an upside risk to the headline inflation rate (less so core inflation) although, if these reforms are well managed and the rise in inflation expectations is capped, these reforms should only lead to a step-up in prices rather than contributing to a sustained increase in inflation.

Together these developments should allow the poverty rate to continue to fall, by around 2½ to 3 percentage points from early 2009 to early 2011, assuming that the government does not introduce new poverty reduction measures.

Table 1: The outlook remains for gradual recovery in growth

		2008	2009	2010	2011
Gross Domestic Product	*(annual % change)*	6.1	4.5	5.6	6.0
Consumer price index	*(annual % change)*	9.8	4.8	5.4	5.9
Poverty rate	*(% population)*	15.4	14.2	13.5	11.4
Balance of payments	*(USD bn)*	-1.9	11.8	5.0	3.0
Budget balance	*(% GDP)*	-0.1	-2.3	-1.7	--
Major trading partner growth	*(annual % change)*	2.4	-0.9	3.8	3.9

[Sources: MoF, BPS and other national statistical agencies via CEIC and World Bank

The government's budget deficit is likely to be slightly below projections in 2009, and may be slightly larger in 2010

The government's 2009 budget deficit is likely to be slightly smaller than projected in the revised budget, near 2.3 per cent of GDP, as below-budget spending (particularly on subsidies and 'other' items) offset weaker-than-projected revenues. Given the government's advanced financing and the strengthening of the exchange rate, this is likely to create a financing surplus, which will help support 2010's financing needs. Moreover, the government's improving disbursement performance together with recent developments in oil prices and the exchange rate suggest that the 2010 budget deficit may be slightly above the approved budget's 1.6 per cent projection.

Risks to the outlook remain significant;

The risks to Indonesia's economic outlook remain significant, and slightly skewed to the downside. The risks to the global economic environment have declined somewhat, although significant downside risks remain particularly as policy makers withdraw the various monetary and fiscal stimulus measures. Meanwhile domestically-sourced risks have risen, as recent domestic political developments have begun to raise questions about the timing and depth of future economic reforms.

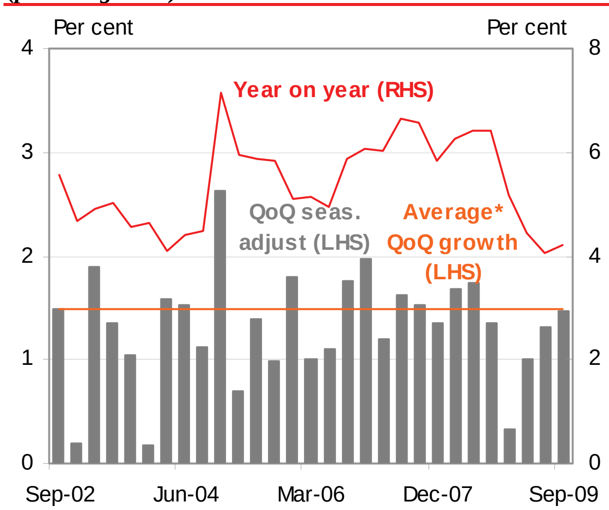
A. ECONOMIC UPDATE

1. Indonesia's economy, less affected than most by the global downturn, has returned to near-pre-crisis growth rates

GDP growth returned to pre-crisis rates in Q3

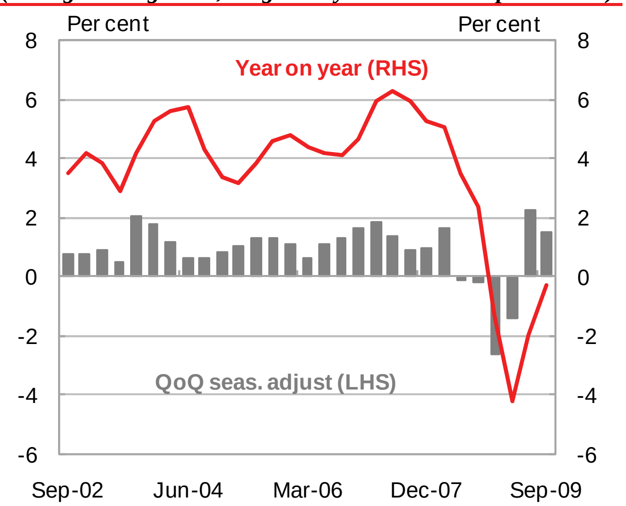
Many of the trends in Indonesia's real economy evident at the time of the September Quarterly continued into the third and fourth quarters of 2009. Movements in Indonesia's real economy remained moderate, with growth and other indicators gradually returning to pre-crisis levels. GDP growth accelerated in Q3, returning to near pre-crisis averages. Year-on-year growth rose slightly, to 4.2 per cent from 4.0 per cent in the year to Q2. The economy expanded by around 1.5 per cent in the quarter (seasonally adjusted) – 6.0 per cent annualized– compared with 1.2 per cent in Q2. (Figure 1). The acceleration in GDP is in line with improved international and domestic conditions. Improved consumer confidence and some softening in lending conditions have supported domestic consumption and investment, while consolidating commodity prices, recoveries in most of Indonesia's major trading partners, and much easier access to finance, have also supported investment, incomes and export demand.

Figure 1: GDP growth returned to pre-crisis averages in Q3
(per cent growth)



* average quarter-on-quarter growth between Q1 2004 and Q2 2008. Sources: BPS, World Bank seasonal adjustment

Figure 2: Growth across Indonesia's trading partners has rebounded
(average GDP growth, weighted by Indonesia's export shares)



Sources: National statistical agencies via CEIC and World Bank

a. Growth was broadly based

Investment picked up, while consumption remains robust

Contributions to growth were broadly based for the expenditure components of GDP (Figure 3). Investment has picked up, with both building and machinery and equipment investment accelerating. Like earlier quarters this year, growth was driven by consumption as well as the external sector. In a year on year basis the falls in imports continue to exceed those in exports, although both grew at a similar pace in Q3. Growth was also broadly based across production sectors (Figure 4), with non-tradable output continuing to grow somewhat faster than tradable output. Transport & communications contributed most to output growth, while wholesale & retail trade remained relatively weak.

Solid domestic demand is consistent with partial indicators

Other consumer indicators suggest robust consumption: consumer confidence reached record highs in July, before retreating later in the quarter; and BI's retail sales index also reached new highs (Figure 6). Motor vehicle and especially motor cycle sales have risen strongly from the start of the year, although are still well down on Q3 2008 (motorcycle sales 9 per cent lower and vehicle sales 27 per cent lower) (Figure 5).

Figure 3: Contributions to GDP expenditure growth
(quarter-on-quarter percentage point contributions to aggregate GDP growth, seasonally adjusted)

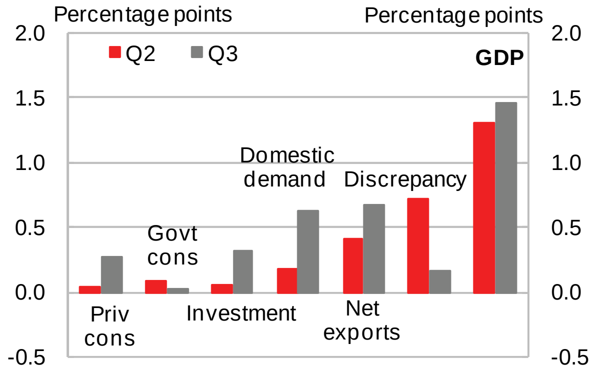
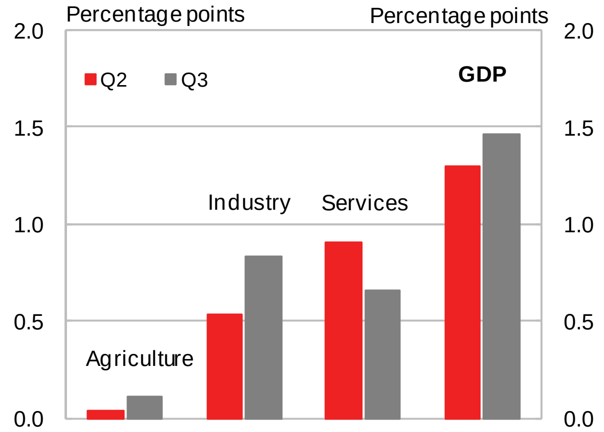


Figure 4: Production sectors' contribution to growth
(quarter-on-quarter percentage point contributions to aggregate GDP growth, seasonally adjusted)

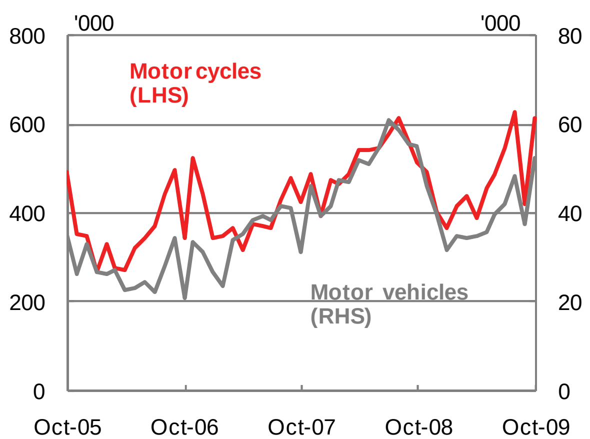


Seasonally adjusted percentage point contributions may not sum to total GDP growth. Sources: BPS and World Bank

Production indicators are mixed

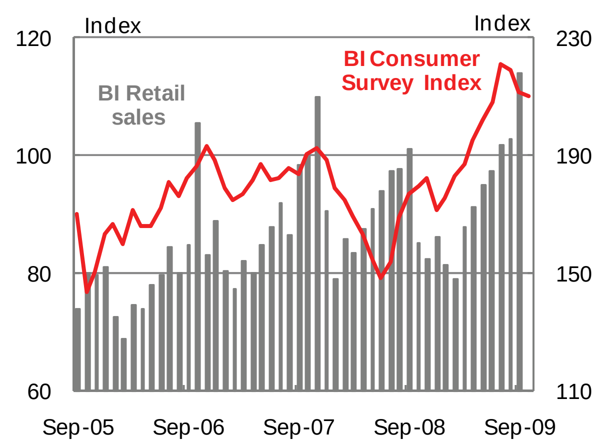
Industrial sector indicators suggest manufacturing activity has risen since the start of the year, but remains weaker than a year ago. Electricity consumed by industry and cement production were both slightly lower in Q3 2009 compared to a year earlier, although September movements must be read cautiously as all of the Idul Fitri holidays fell in that month this year. But both indicators have risen considerably since the start of 2009. The industrial production index reported moderate increases in activity since both Q2 and a year ago (around 2 per cent).

Figure 5: Motor vehicle and motorcycle sales
(monthly purchases)



Sources: GAI and Astra via CEIC

Figure 6: BI retail sales and consumer confidence
(indices)



BI consumer confidence index is at 100 when the number of respondents with a positive outlook equals the number with a negative outlook. Source: BI via CEIC

Net exports continued to contribute to growth as merchandise trade flows recover

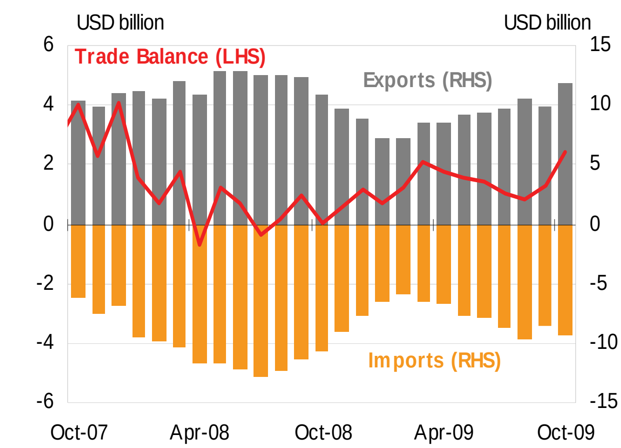
Net exports continued to support economic growth in Q3 – as export volumes continued to rebound more quickly than import volumes. Monthly trade flows continued to recover from their early 2009 lows in August through October, with both import and export values rising around two-thirds over this period. These gains have been supported by a recovery in demand as the world economy emerges from recession, and gains in global commodity prices support values, which have led Indonesia's export prices higher, (Figure 8) Recent monthly data have been volatile due to the holiday effect, and to three months of nickel exports being recorded in October. But even controlling for these effects, trade flows continued to recover into Q4, with exports rising 6 per cent in October, supported by electronics, mineral fuels and rubber exports. Import growth has remained more sluggish, as capital goods imports, which were not as severely affected by the downturn, have picked up less (particularly for vehicles, electronics and machinery parts) and iron & steel imports remained soft.

Services imports also continued to recover in Q3, growing by 2.5 per cent Q-o-Q — primarily due to higher spending on freight with the increase in Indonesia's merchandise trade flows and recovery in global freight rates. However, service exports contracted slightly (by 0.8 per cent in the quarter), predominantly due to reduced business and government service exports. Tourist arrivals were up.

…narrowing the current account surplus

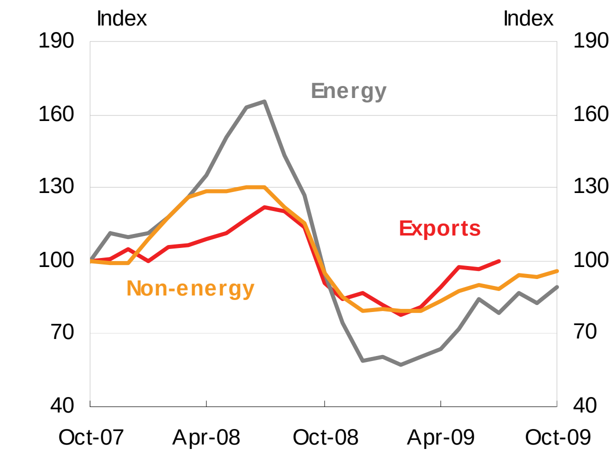
Indonesia's current account surplus narrowed in Q3 relative to Q2. The stronger recovery in the nominal value of imports in Q3 relative to exports narrowed Indonesia's trade surplus. The wider income deficit added to this, as higher commodity prices led to increased outflows of income and profits from foreign investors in the oil & gas sector.

Figure 7: Trade flows are recovering…
(trade values and balance, billions of USD)



Sources: BPS and World Bank

Figure 8: …supported by global commodity prices, which are lifting Indonesia's export prices
(USD prices, indexed to 100 in July 2007)



Sources: World Bank global commodity prices. Indonesian export prices calculated by World Bank from BPS trade data

b. The economic recovery, with higher global commodity prices, has stabilized inflation at decade lows

After gaining momentum in the third quarter, prices were stable in October and November

From mid year to the Idul Fitri holidays, consumer prices accelerated from the very low inflation rates of the first half of the year. But even at the peak during Ramadan, when retailers raise prices with the higher demand for many consumer items, monthly inflation was no higher than in the equivalent period in earlier years. In October, after the Idul Fitri holiday week, when workers came back to work and demand returned to normal patterns, many of the Ramadan-related price rises, such as for many food items and for inter-city transport, were at least partly reversed, giving a low monthly inflation rate. Good fresh food supply, and some pass-through of the appreciating exchange rate, led average consumer prices to fall very slight between October and November. By November, headline year-on-year inflation had fallen to 2.4 percent, the lowest rate since early 2000.

…with falls in volatile prices adding to the general weakness in inflation

While some fresh food (eggs & dairy products, beans & nuts, and fats & oils) and most transportation prices have been especially weak from September to November, inflation for most other items has slowed too. Core inflation, which excludes the volatile and administered (including regulated fuel) prices, remains about 2 percentage points above the headline rate, although it too has fallen to decade-lows, at 4.3 per cent in the year to November. The general disinflation has benefited poor households too, although they continue to experience price growth about 1 percentage point faster than the average Indonesian consumer. The cost of a poor household's consumption bundle rose by 3.2 per cent in the year to November.

The rupiah's appreciation has muted price growth

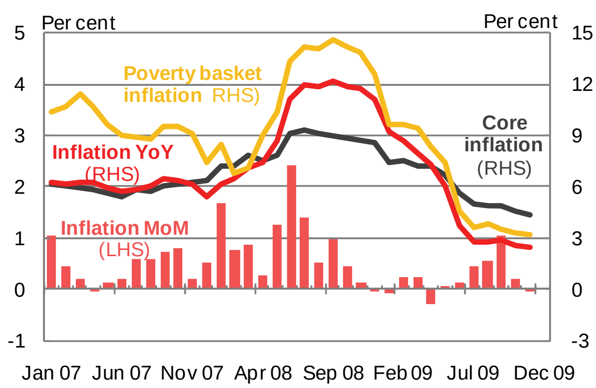
The appreciation of the rupiah does appear to have muted price growth somewhat (against the USD, the rupiah appreciated 8.3 per cent in the six months to November). Econometric estimates suggest that the rupiah's appreciation is likely to have reduced inflation by 0.3 to 0.6 percentage points, with several tenths of a percentage point of further disinflation expected by early 2010. And this is evident in the prices of some of the more tradable items in the CPI. For example, in the six months to November, 'equipment' (for transportation, education and the household), medicines, and women's and children's clothing prices have all increased by less than the overall CPI – but the difference in growth was small (0.4 to 1.1 percentage points weaker than the overall CPI over the 6 months) and inflation was weaker for many associated services.

The appreciation's impact has been greater for upstream prices. The overall wholesale price index (WPI) fell by 3.5 per cent in the year to October, due partly to significantly lower rupiah prices for Indonesia's exports, which in turn appear to be feeding into industry prices, which were down by 8.2 per cent in the year to October.

Economy-wide prices have also slowed, but continue to increase faster than the CPI

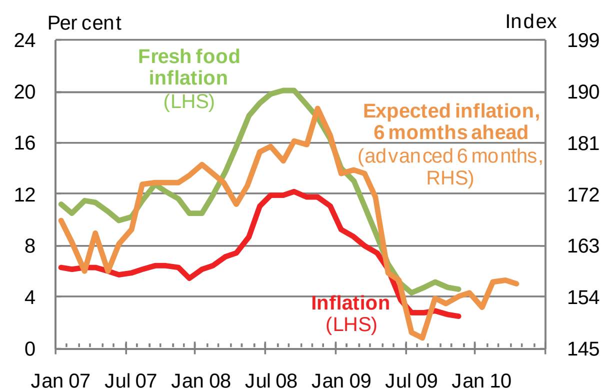
Growth of other prices has slowed too. The implicit GDP deflator, measuring prices across the economy, grew by 4.6 per cent in the year to Q3, the slowest rate since early 2004. Quarterly price growth slowed in Q3 relative to Q2, with export prices falling and investment good prices increasing by 1.0 per cent from Q2 to Q3, the slowest quarterly rate since 2003. The national accounts implicit price deflators give a broader perspective on price movements across the economy than the consumer price index. The CPI reports the prices of the basket of goods and services consumed by the average urban household (weighted by expenditure), an important but incomplete picture of national prices, given that private consumption accounts for 60 per cent of GDP and half of Indonesia's households live outside urban areas.

Figure 9: The pick-up in inflation earlier in the second half of 2009 has not continued, allowing inflation to fall to decade lows
(year-on-year and month-on-month inflation rates)



Sources: BPS and World Bank estimates of poverty basket inflation

Figure 10: …and consumers expect prices to be stable into the first half of 2010
(year-on-year inflation rates and index point level of inflation expectations)



Sources: BPS and BI via CEIC

Inflation expectations are rising faster than actual inflation

Consumers' inflation expectations have also stabilized since August above the Q1 trough (almost 7 per cent higher). Consumers expect transportation & communications prices particularly to rise in the coming 6 months, despite this being the weakest group of prices currently. Businesses continued to reduce their expectations of future inflation to historically low levels, with almost half the respondents to BI's survey expecting inflation below 7 per cent.

2. Indonesia's financial indicators remain volatile, rising by more than most

a. The balance of payments remained in surplus in Q3, with capital flowing into Indonesian financial assets

The BoP surplus expanded in Q3, due to a turnaround on the financial account…

The balance of payments (BoP) surplus increased to USD 3.5 bn in Q3 due to a turnaround on the financial account to a surplus of USD 3.0 bn, somewhat offset by a narrowing in the current account surplus, to USD 1.7 bn. (Table 2) The additional allocation of 1.74 bn of special draw rights (USD 2.7 bn) to Indonesia by the IMF on August 21, contributed to this surplus, as did large foreign purchases of SBIs. This was somewhat offset by large transfers by Indonesian residents to foreign bank accounts.

The surplus on the BoP – and in particular, the additional SDR allocation – saw Indonesia's foreign reserves rise to USD 65.8 billion at the end of November, surpassing the pre-crisis peak of July 2008.

Upgraded ratings of Indonesian sovereign debt have supported inflows

Ratings upgrades of Indonesia's sovereign debt have supported inflows, although their timing means the impact is likely to be greater in Q4. On 16 September Moody's upgraded Indonesia's foreign and local-currency sovereign debt ratings to Ba2 from Ba3, citing the nation's economic resilience during the global financial crisis. A month later, Standard & Poor's upgraded its outlook for the Indonesian economy to positive from stable, and reaffirmed its 'BB-' long-term foreign currency and 'BB+' long-term local currency sovereign credit ratings, citing cautious macro policies and the reform-minded leadership.

Table 2: The turnaround on the financial account expanded the balance of payments surplus, allowing reserves to rise
(billions of USD unless otherwise stated)

					2008				2009		
	2005	2006	2007	2008	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Balance of Payments	.4	14.5	12.7	-1.9	1.0	1.3	-.1	-4.2	4.0	1.1	3.5
Per cent of GDP	*0.2*	*5.1*	*3.5*	*-0.5*	*0.8*	*1.0*	*-0.1*	*-3.8*	*3.5*	*0.8*	*2.4*
Current Account	.3	10.9	10.5	.1	2.7	-1.0	-1.0	-.6	2.7	2.9	1.7
Per cent of GDP	*0.1*	*3.8*	*2.9*	*0.0*	*2.3*	*-0.8*	*-0.7*	*-0.6*	*2.4*	*2.2*	*1.2*
Trade Balance	8.4	19.8	20.9	9.9	4.5	2.1	2.5	.9	4.3	5.4	4.6
Net Income & Current Transfers	-8.1	-8.9	-10.4	-9.8	-1.7	-3.1	-3.4	-1.6	-1.6	-2.5	-2.9
Capital & Financial Accounts	.3	3.0	3.6	-1.9	-.5	2.1	2.4	-5.8	1.9	-2.2	3.0
Per cent of GDP	*0.1*	*1.1*	*1.0*	*-0.4*	*-0.4*	*1.6*	*1.6*	*-5.2*	*1.7*	*-1.7*	*2.0*
Direct Investment	5.3	2.2	2.3	3.4	.6	.2	1.9	.7	.8	.2	-.1
Portfolio Investment	4.2	4.3	5.6	1.7	2.0	4.2	-.1	-4.4	1.9	2.0	3.4
Other Investment	-9.4	-3.8	-4.8	-7.3	-3.2	-2.3	.4	-2.2	-.8	-4.5	-.4
Errors & Omissions	-.2	.6	-1.4	-.2	-1.2	.2	-1.5	2.2	-.7	.4	-1.2
Foreign Reserves*	34.7	42.6	56.9	51.6	59.0	59.5	57.1	51.6	54.8	57.6	62.3

* Foreign reserves at end of September. Reserves rose to USD 65.8 billion at end November.
Sources: BI, BPS via CEIC and World Bank

Capital flows continue to generally 'normalize'

While volatile by nature, flows in the financial accounts continued to return to more normal patterns in Q3, following the turbulence around the turn of the year. Non-resident portfolio investors returned as significant purchasers in equity and bond markets after reducing their holdings in recent quarters. Corporations have re-entered offshore debt markets after a prolonged period of absence, consistent with the surge in funds globally to emerging market corporate bond issuers. Finally, trade credits have approached pre-crisis levels – consistent with increased trade activity and improved financial conditions.

…although foreign direct investment has weakened further, particularly in the oil & gas sector

One important exception to this normalization was a further fall in foreign direct investment (FDI), as investors in oil & gas reduced their investments and withdrew more funds from the sector, while non-oil & gas investment remained weak. Indonesians' investments offshore fell to USD 0.5 billion in the quarter, about one-third of their usual level.

…and residents are shifting unusually large amounts into offshore bank accounts

The other exception is Indonesian residents continuing to shift substantial amounts of funds into bank deposits overseas. A total of USD 10 billion has been invested offshore in the year to Q3, the most in any four quarters on record. The size of these transfers in Q3, USD 3.5 billion, is unusual given the strengthening market conditions in this period, with past episodes of significant transfers offshore occurring when financial markets have been weakening rapidly. Some of these funds may have made their way back into Indonesia through 'offshore' investments in financial markets.

b. Equity and fixed income markets and the rupiah have continued the strengthening trend, at a slowing pace

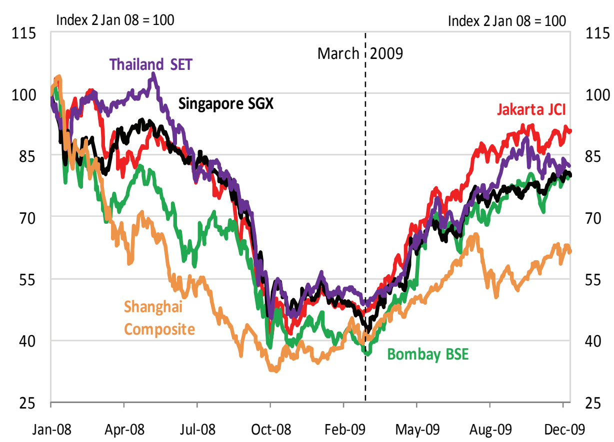
The IDX composite has gained 92 per cent since March making it the top regional performer after the Bombay Stock Exchange

While major Asian equity indices have all performed well in the last six months, the JCI's 92 per cent gain since March is beaten only by the performance of the Bombay Stock Exchange, which rose by 109 per cent over the same period (Figure 11). Like most markets, the rate of growth has slowed since late September. After passing 2500 points in mid-October to trade at levels last seen in early March 2008, the JCI dipped slightly at the end of October with speculation that the recovery in global financial markets had been overplayed, and as some of the positive market sentiment surrounding domestic political developments eased. However, the sell-off was short-lived and equities inched back up through the second half of November.

The Rupiah has appreciated significantly against the USD and other currencies over the past six months, although it is still somewhat below pre-September 2008 levels

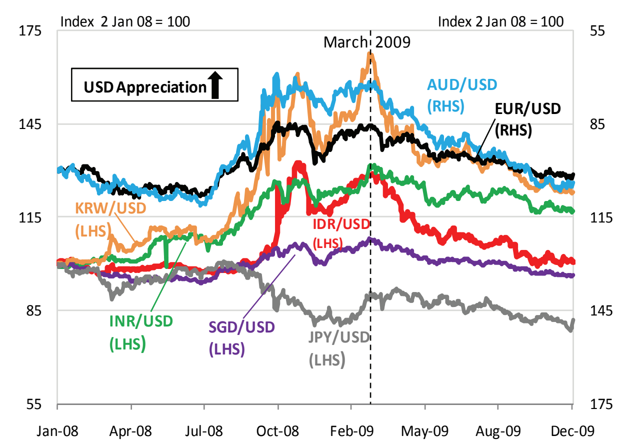
Similarly, the rupiah has appreciated significantly against the USD and other major currencies in the past six months, before stabilizing to a narrowrange around 9,450 from early October to early December. Since March, the currency has gained 22 per cent against the USD, over 13 per cent against the euro and Singapore dollar, and 8 per cent against the British pound. The movement in IDR/USD has been particularly marked and has therefore raised some concern among Indonesian authorities regarding the sustainability of the appreciation as well as its impact on competitiveness. While the magnitude of the Rupiah's rise versus the USD is not unusual given the high volatility ('beta') of Indonesian financial markets, the USD has weakened against most regional and major currencies indicating more than a rupiah story is at play (Figure 12). For example, since March the Korean won has gained 26 per cent against the USD, and the Australian dollar has appreciated by 47 per cent. The rupiah's appreciation has taken it towards levels it was trading at against the USD in August 2008, while the Indian rupee and Korean won are both still considerably weaker than they were pre-crisis. (Part B examines the recent rupiah appreciation and its drivers in more detail.)

Figure 11: The IDX has risen more than most regional indices, before tracking sideways from late September
(equity indices indexed to 100 on 2 January 2008)



Sources: FRB, CEIC and World Bank

Figure 12: …and the rupiah's appreciation against the USD is the second strongest in the region
(currency pairs indexed to 100 on 2 January 2008)



Sources: CEIC and World Bank

Indonesian rupiah and USD denominated sovereign bond yields have fallen to 2007 levels with loose monetary policy, low inflation and strong demand

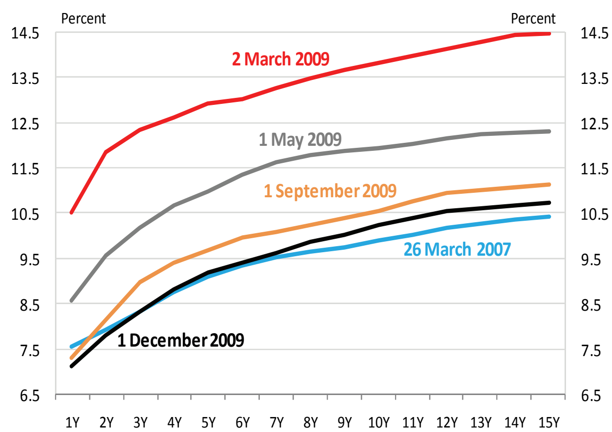
Indonesian local currency and USD denominated sovereign bonds continued the strengthening trend that started in March into September, before flattening to a 50 basis point range from October to December, as monetary policy remained loose and inflation numbers in October and November were below market analysts' expectations. Over the past three months, yields across the entirety of the curve have moved in parallel, and by early December the yield curve was down to early 2007 levels (Figure 13). Five year IDR government bond yields have fallen by 33 per cent since March, from nearly 14 per cent to about 9.35 per cent in late November. In spite of these declines, Indonesian local currency bond yields remain higher than those elsewhere in the region.(Figure 34)

Indonesian EMBI USD bond spreads have also recovered to late 2007 levels (Figure 14), and remain below the global average emerging market spread to US Treasuries. Since countries' EMBI spreads are often taken as a proxy for measuring "country risk", Indonesia's narrowing spreads may have served to indicate lower country risk in recent months and thereby helped attract investors and capital into Indonesia's financial markets.

Fuel subsidy reform and lower government financing needs in 2010 should support bond prices

Going forward, the government's possible energy subsidy reform agenda in 2010 could reduce bond yields. The current fuel pricing system, where prices are moved towards the economic cost of fuel in large, *ad hoc* adjustments, generates uncertainty over the future path of inflation and may contribute to higher inflation expectations and hence Indonesia's structurally higher inflation rate. It also creates uncertainty over the government's financing needs and hence the number of bonds the government will sell each year, as higher economic costs of energy and irregular price adjustment make the cost of the government's energy subsidies higher and more volatile. These two effects lead investors to demand higher bond yields, especially for longer-term bonds, to protect against the higher inflation and greater potential volatility in bond prices. In addition, the smaller than expected fiscal deficit this year has lowered the government's financing needs for 2010. This will mean lower bond issuance needs next year and should therefore also help support bond prices.

Figure 13: Local currency government bond yields, steadily falling across all tenors since March, have returned to early 2007 levels
(yields on 1 year to 15 year IDR sovereign bonds, percent)



Sources: CEIC and World Bank

Figure 14: Indonesian sovereign USD bonds have settled at levels slightly above their historical average, but have strengthened by more than most emerging market debt
(Indonesian EMBI spreads to US Treasuries and difference between Indonesian spreads and global emerging market average, both in basis points)

Sources: JP Morgan, Datastream and World Bank

The strength in financial market prices has not passed into other asset prices

The strong recovery in financial asset prices in other economies in the region has lifted nonfinancial asset prices too, particularly those for apartments and commercial property, while rents have been stable or fallen. The opposite appears to have been the case in Indonesia's urban property market. Growth in selling prices of apartments, offices, retail and industrial space in the Jabodebek (greater Jakarta) region all slowed to near zero by Q2 or Q3 of 2009, from growth rates around 15 percent in 2008 for offices and apartments. This slowdown may reflect market balances, with slight rises in vacancy rates and falls in selling rates through the first three quarters of 2009. Despite these developments, rents have continued to grow relatively strongly (by 11.6 percent in the year to Q3 for apartments, although rental growth rates have slowed since late 2008 for all property types).

c. The gains in financial markets and the exchange rate have been partly due to significant capital inflows

Large inflows of offshore funds have played an important role in strengthening financial asset prices and the rupiah

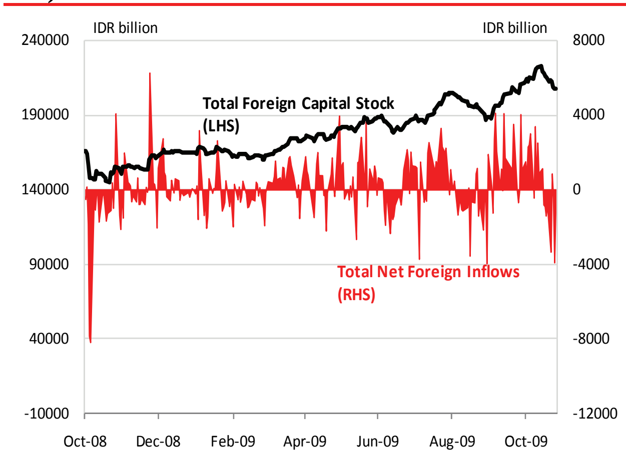
An important contributing factor to capital market and rupiah strength from March to December has been large inflows of foreign capital into Indonesia. Non-residents have invested approximately USD 6.5 billion (net) in Indonesian financial assets since March, with much of these funds entering in September and early October. This inflow of capital has increased overall foreign holdings of Indonesian equities, government bonds and short-term money market instruments by 28 per cent (Figure 15). Since non-residents' holdings represent a significant share of Indonesia's relatively shallow financial markets, such movements of foreign capital can have a sizeable impact on asset prices.

Mostly carry trade driven, these inflows provide more funds for investment, but can also be destabilizing if investors change sentiment suddenly and withdraw these funds

The reasons behind these inflows are not unique to Indonesia but rather linked to low interest rates in the United States and the weakening USD, which have led investors to put on large carry trades to take advantage of higher yielding assets in emerging markets. While such inflows are positive in so far as they give a kick start to the economy and market, they can be destabilizing if they are purely arbitrage driven and therefore leave the country as quickly as they came in. Indonesia's open capital markets and high interest rate differentials make it a particularly attractive haven for such inflows but also leave the country especially vulnerable to sudden reversals in investor sentiment.

Figure 15: Indonesia has absorbed USD 6.5 billion in foreign capital since March, USD 2.6 billion of this in September and early October

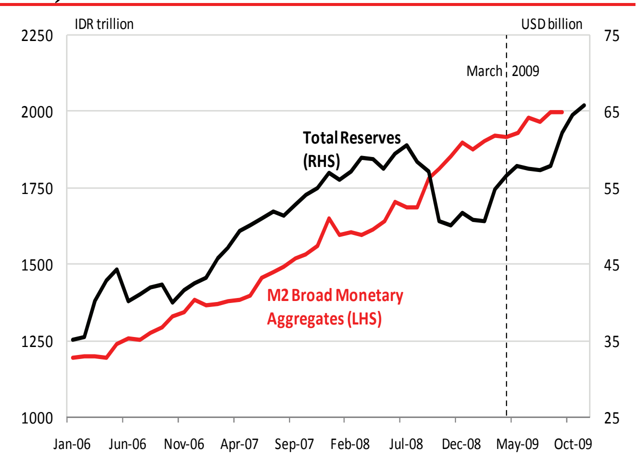
(net inflows and total foreign capital stock of equities, government bonds and money market instruments, billions of IDR)



Sources: BI, CEIC and World Bank

Figure 16: Reserves have increased strongly since March while M2 growth has been slow, suggesting BI has been sterilizing its foreign exchange interventions

(M2 in trillions of IDR; international reserves in billions of USD)



Sources: BI, CEIC and World Bank

The build-up of international reserves and muted growth in the money supply since March suggest that BI sought to offset the impact of capital inflows on the exchange rate and monetary base

In order to neutralize the impact of capital inflows on the exchange rate and monetary base, central banks can intervene in the foreign exchange market by buying foreign currency in exchange for local currency, then using open market operations to remove extra liquidity that was created in selling the rupiahs. BI appears to have done this to a degree. International reserves rose by 23 per cent from early March (when the rupiah started a sustained appreciation against the USD) from USD 53.7 billion to USD 65.8 billion at the end of November (Figure 16). This USD 12.1 billion rise is equivalent to 6.3 per cent of the money base (M2) in March, and, without sterilization, the money base would be expected to accelerate by this rate in addition to its trend growth. Instead, growth in the money supply has been unusually slow during this period, rising at an annualized rate of 8.3 per cent between March and September, compared with average growth of 18.3 per cent in 2006 and 2007.

BI appears to have been reabsorbing some of the extra money supply it has created in intervening in the foreign exchange markets by issuing more short-term money market instruments. The stock of SBIs on issue more than quadrupled over this period, rising the equivalent of USD 3.5 billion. This occurred at the same time as BI was easing monetary policy – and would therefore usually be expected to be buying back SBIs in order to increase the money supply. This combination of building reserves and selling SBIs is costly for BI, as it earns low interest on its international reserves, while paying high yields of 6.5 percent on the SBIs it issues. All in all, while it is often difficult for central banks in emerging economies to fine tune short-run changes in the monetary base through open market operations, BI appears to have been fairly effective in limiting the impact of rapidly increasing reserves on the money supply.

d. Despite the overall robustness of the banking sector, credit growth is showing only moderate recovery

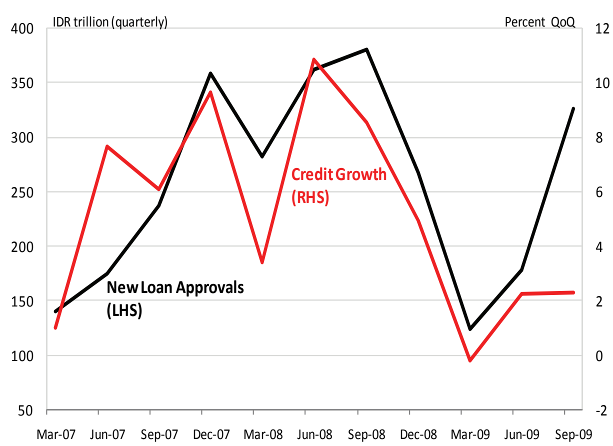
The banking sector remains in good health overall, according to financial ratios and earnings reports

Earnings of major banks and various aggregate indicators such as capital adequacy and return on assets suggest the health of the overall banking sector remains robust. In September, commercial banks' non-performing loan ratios fell to 3.8 percent, slightly above the 2008 average of 3.6 percent, but still well below the 2007 and 2006 averages of 5.6 percent and 8.0 percent, respectively.

…but lending growth has only shown a moderate recovery in recent months

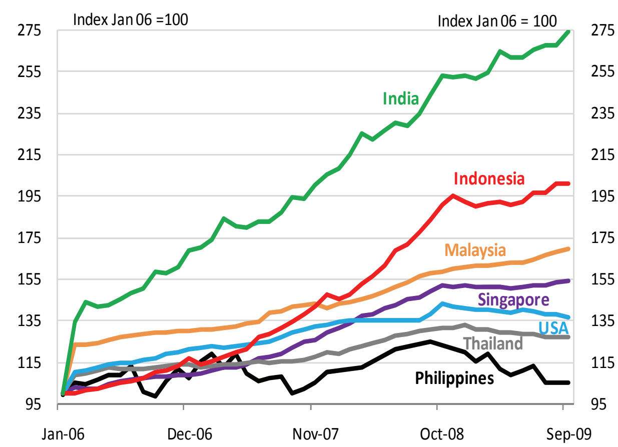
Despite the overall buoyancy in the banking sector, credit growth remains slow, although it has risen since Q2. (Figure 17) Lending has grown by 6 percent in 2009 to date, compared with 32 per cent in 2008. Further acceleration may be likely, given that new loan approvals returned to their mid 2008 levels by Q3 2009. (Figure 17) While lending has stalled in many economies in the region this year (India notwithstanding), Indonesia's slowdown is conspicuous due to the fast pace of lending in the prior two years, which came to an abrupt halt in October 2008. (Figure 18).

Figure 17: Credit growth dropped sharply after September 2008 but has picked up since mid-2009
(quarterly new loan approvals in IDR trillion; credit growth in percentage change quarter-on quarter)



Sources: CEIC and World Bank

Figure 18: While other countries (apart from India) have seen credit slowdowns as well, Indonesia's stands out due to its rapid credit growth in the two years prior to October 2008
(commercial bank lending indexed to 100 in January 2006)



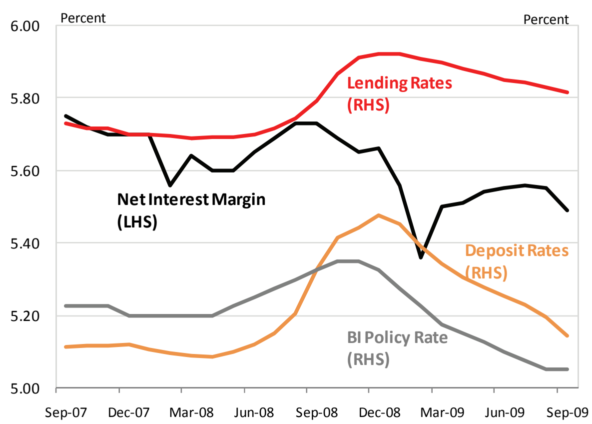
Sources: FRB and BI via CEIC and World Bank

Lending rates remain at high levels despite BI's 300 bps policy rate cut and attempts to reduce the cost of funds by capping deposit rates

Among the supply- and demand-side factors causing the slowing in lending, the high cost of borrowing has stood out. Lending rates have remained above 14 percent since October 2008, despite BI's 300 basis point cut to its policy rate between December and August this year. Indonesia was the only country in the region to have *higher* lending and deposit rates in June 2009 compared to a year earlier, in spite of the central bank's policy rate cuts. (Figure 18)

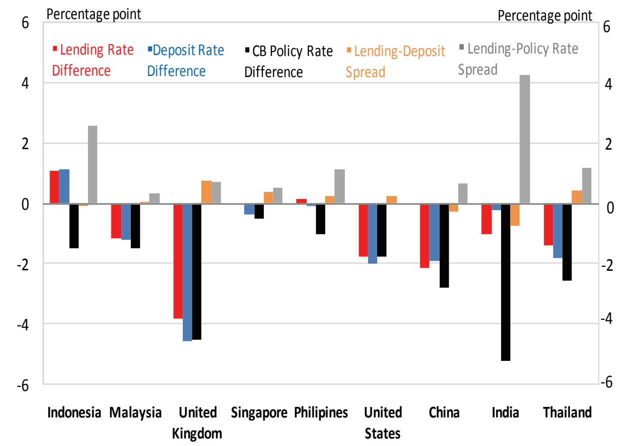
BI sought to reduce lending rates in August by asking the 14 largest commercial banks to sign a voluntary agreement to cap deposit rates. This agreement was intended to reduce interbank competition for funds. By October, the effect appears to have been limited, with deposit rates falling 100 basis points from June, while lending rates dropped by only 35 basis points. Since rates peaked around the turn of the year, lending rates have only fallen 106 basis points, while deposit rates have decreased by over 330 basis points. International experience has been that this approach of capping and, in effect, regulating deposit and lending rates, has not been effective in addressing structural problems in the banking sector that limit investors' access to funds.

Figure 19: Despite various policy actions by the central bank, lending rates have only dropped 7 percent since January while deposit rates have fallen by 31 percent
(net interest margin, lending and deposit rates, per cent)



Sources: CEIC and World Bank

Figure 20: Indonesia is the only country where lending and deposit rates *rose* in the year to June 2009
(rate differences between June 2008 and June 2009, percentage points)



Sources: FRB and BI via CEIC and World Bank

The rigidity of lending rates has allowed net interest margins to remain relatively high compared to other countries in the region

This stickiness in lending rates, while deposit rates have fallen, has meant that net interest margins (NIMs) have remained at or above 5.5 percent since March, compared to other countries in the region where NIMs range between 3-4 percent. While high net interest margins may make Indonesian banks some of the most profitable in the region, the burgeoning spread between lending rates and deposit and savings rates increases the cost of investment and consumption smoothing, and so may limit economic growth.

…and BI aims to lower these by mid 2010

In light of this, in mid-November BI stated that it will encourage the banking sector to reduce net interest margins by June 2010. Before issuing a formal policy, the central bank plans to first conduct a detailed study on the cost structure of Indonesia's banking industry. It is also uncertain whether reducing net interest margins would actually lead to an increase in banks' lending. Due to the post-crisis tightening of credit standards and the downward pressure on lending rates this year, banks have been increasingly investing in government bonds and money market instruments, which provide relatively high and risk-free yields, as opposed to lending. Further pressure to narrow net interest margins and bring lending rates down could make banks even more averse to lending, and simply serve to increase their reliance on government bond investments and fee-based income.

3. The economic outlook is expected to be a little stronger than last quarter, with an ongoing, gradual recovery

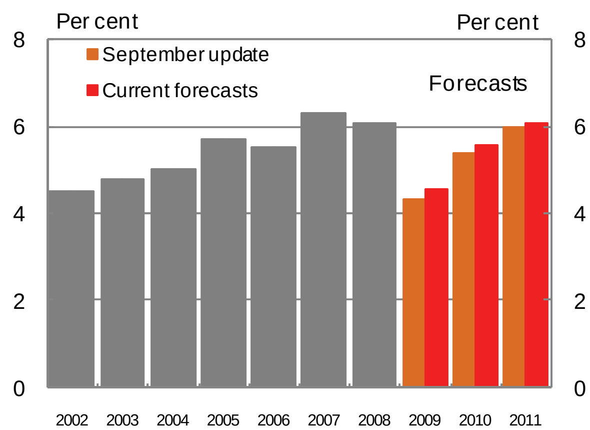
Indonesia's growth outlook has risen slightly in the past three months

The outlook for Indonesia's economy has improved over the last three months (Figure 21). The economy is expected to grow by 4.5 per cent in 2009, higher than the previous forecast of 4.3 per cent, due to the stronger-than-expected outcomes across Indonesia's trading partners mid-year, consolidation of higher commodity prices, and somewhat stronger-than-expected Q3 Indonesian GDP outcome. In 2010 growth is expected to rise to 5.6 per cent, higher than the 5.4 per cent expected previously. Growth is expected to return toward trend of around 6 per cent from 2011. The improved outlook follows the slightly stronger than expected Q3 GDP and improved external environment and outlook.

Investment growth is expected to rebound while government spending will remain strong

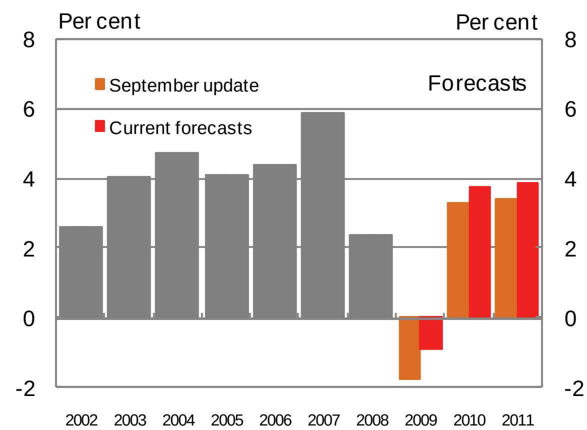
The major drivers of Indonesia's growth in 2010 are expected to continue to come from domestic demand, with support from a recovery in the external sector (Table 3). Private consumption expenditure is expected to accelerate, growing by around 5.1 per cent in 2010 with the continued impact of the fiscal stimulus, moderate price growth and improving incomes. Investment growth is also expected to accelerate in 2010, as increasing commodity prices and external demand, and easier access to finance, support investors' plans. Government consumption is expected to continue growing with greater spending on core government programs and improved disbursement rates.

Figure 21: Indonesia's growth outlook improves
(annual average GDP growth, per cent)



Sources: BPS and World Bank forecasts

Figure 22: …along with the outlook for trading partners
(average annual GDP growth of Indonesia's export destinations)



Sources: CEIC, Consensus Forecasts Inc and World Bank

Inflation is expected to accelerate gradually, as the stronger rupiah offsets the firmer outlook for growth and commodity prices

After being a little stronger than expected in August and September and then weaker than expected in October and November, the outlook for CPI inflation in 2009 has changed little, with an annual rate of 4.8 per cent. The pickup in GDP growth and commodity prices that has occurred since Q2 and that is projected to continue over the forecast horizon should feed into a gradual acceleration in prices, with annual inflation rates rising to 5.5 to 6 per cent range in 2010 and 2011. The additional appreciation of the rupiah in the past few months has lowered the outlook – latest estimates suggest that a 10 per cent appreciation of the rupiah against the USD lowers prices by 0.6 to 0.9 per cent over about 6 months, suggesting that the appreciation up to October will limit price growth into the second quarter of 2010.

The inflation rate experienced by poor households, and the core inflation rate (excluding volatile and administered prices), are projected to slowly converge with the headline rate while following a similar path, rising towards 6 per cent in 2010 and remaining at that rate into 2011. The exchange rate's appreciation is projected to have a larger impact on core inflation, and a smaller impact on poor households' inflation rate (as a relatively larger share of poor households' consumption basket is spent on items with prices that are domestically determined).

Specific policy initiatives to better target energy and other subsidies and to allow regulated prices to move more in line with economic costs have yet to be announced, beyond some limited adjustment to bring some electricity tariffs closer to the cost of supply and in some LPG prices; both of these initiatives have little impact on the overall CPI. Such reforms do present a risk to the inflation projections, as prices undergo a one-off upward step.

Poverty is likely to continue to fall, modestly

These projections suggest the official poverty rate is likely to continue to fall, from 14.2 per February 2009 to around 13.5 per cent in early 2010 and 11.4 per cent in early 2011. Like the larger macroeconomic environment, these projections have changed little in the last three months, although household-level data from the latest household survey has reduced the projected rate of poverty reduction for technical reasons. Poverty reduction is likely to be supported by the planned expansion of the PKH and PNPM Mandirii programs, with other targeted poverty reduction policies currently under development; in the longer-term the government's 100 day plan also features various other policy measures that may accelerate poverty reduction indirectly.

Table 3: Indonesia's macroeconomic indicators
(percentage change, unless otherwise indicated)

d

	Annual				Year to December quarter				Revisions to Annual		
	2008	2009	2010	2011	2008	2009	2010	2011	2009	2010	2011
1. Main economic indicators											
Total Consumption expenditure	5.9	6.0	5.6	5.4	6.4	5.1	5.1	5.4	0.8	0.7	0.4
Private consumption expenditure	5.3	5.0	5.1	5.3	4.8	4.7	4.9	5.3	0.5	0.4	0.3
Government consumption	10.4	12.7	8.8	5.8	16.4	7.7	8.9	6.1	1.9	2.6	1.1
Gross fixed capital formation	11.7	3.7	9.0	7.4	9.1	4.7	8.5	6.9	1.0	0.8	0.6
Exports of goods and services	9.5	-11.4	8.8	10.8	1.8	-3.0	6.7	12.6	0.7	-0.8	-0.5
Imports of goods and services	10.0	-19.5	12.6	12.1	-3.5	-8.7	9.3	13.6	-1.0	-0.6	0.4
Official poverty rate (%)	15.4	14.2	13.5	11.4	n/a	n/a	n/a	n/a	n/a	-0.1	-0.1
Gross Domestic Product	**6.1**	**4.5**	**5.6**	**6.0**	**5.2**	**5.4**	**5.6**	**6.1**	**0.2**	**0.2**	**0.1**
2. External indicators											
Trade balance (USD bn)	9.9	17.7	10.0	10.9	n/a	n/a	n/a	n/a	0.8	-1.9	-0.3
Balance of payments (USD bn)	-1.9	11.8	5.0	3.0	n/a	n/a	n/a	n/a	-0.2	-3.0	0.8
Financial account balance (USD bn)	-2.2	4.5	4.1	2.7	n/a	n/a	n/a	n/a	1.0	-1.4	-0.4
3. Other economic measures											
Consumer price index	9.8	4.8	5.4	5.9	11.5	2.7	6.0	6.3	0.1	-0.3	-0.6
Poverty basket Index	11.6	5.8	5.4	5.9	13.5	2.9	6.4	6.2	0.1	-0.3	-0.4
GDP Deflator	18.2	7.3	9.2	10.9	17.1	6.0	7.4	13.0	-1.7	-2.1	0.9
Nominal GDP	25.4	12.1	15.3	17.6	23.1	11.8	13.3	19.8	-1.6	-1.9	1.1
4. Economic assumptions											
Exchange rate (IDR/USD)	9757	10362	9500	9500	11365	9500	9500	9500	-153	-500	-500
Interest rate (SBI, 1 month)	8.7	7.1	6.5	6.5	9.4	6.5	6.5	6.5	-0.2	-0.5	-0.5
Indonesian crude price (USD/bl)	97.0	60.9	79.0	83.6	52.8	72.5	81.3	84.5	0.7	4.9	8.0
Major trading partner growth	2.4	-0.9	3.8	3.9	-1.3	3.0	3.2	4.2	0.9	0.5	0.5

Notes: Projected trade flows relate to the national accounts, which may overstate the true movement in trade volumes and understate the movement in prices. The national accounts reported that the Rupiah value of exports fell by 15 per cent in the year to mid-2009—consistent with the balance of payments data—while the volume of exports fell by almost 16 per cent, imply that Indonesia's export prices, in rupiah terms, rose by 1.3 per cent, notwithstanding the collapse in commodity prices over this period and 12 per cent depreciation of the rupiah.

The outlook remains for a strong rebound in trade flows in 2010 and 2011, following contractions in 2009…

The outlook for trade flows in 2009 remains for imports to fall by more than exports, due to larger contractions in imports earlier in the year; the recovery in Q3 was in line with earlier expectations. The gradual recovery in the world economy and higher commodity prices are expected to support firm growth in Indonesia's exports volumes and prices over the forecast horizon (Table 3, Table 4), with volumes reaching pre-crisis levels by early 2011. Values should rise even faster – and accelerate into 2011 – supported by rising commodity prices. Imports are expected to recover faster than exports, as the domestic economy grows more quickly than Indonesia's export destinations and the growth in production of export items demands more imported inputs.

…with stronger growth in imports narrowing the trade surplus

The 2009 trade surplus is expected to remain near USD 17.7 billion, before narrowing in 2010 to around USD 10 bn with the projected faster recovery in imports than exports. The surplus is expected to be stable in 2011, as nominal exports and imports both register annual growth of around 19 per cent.

The balance of payments is likely to be in surplus in 2009…

The balance of payments (BoP) is expected to register a slightly smaller surplus in Q4 2009, as the trade balance narrows, the government issues only a small amount of new debt to meet its financing needs, Indonesian residents reduce the transfer of deposits offshore, and as portfolio inflows slow. As a result, the BOP is expected to register a surplus of around USD 12 bn in 2009.

…before narrowing in 2010 and 2011, as the recovery in commodity prices and imports bring the current account to balance.

Consistent with the September *IEQ*, the BoP surplus is expected to narrow through 2010 and 2011, as the current account approaches balance. Ongoing surplus should support continued accumulation of reserves. (Table 3) The current account is expected to move towards balance through the forecast horizon, as the trade balance continues to narrow and the income deficit continues to widen due to higher expected repatriation of profits to foreign equity holders, as oil & gas production increases and global energy prices recover. Remittances from Indonesians working abroad are expected to be stable.

Net direct investment is expected to improve as domestic growth picks up and the global economic recovery consolidates. Offsetting this is the projection of slightly smaller surplus on portfolio investment, as domestic residents place more funds in foreign equity and debt markets. On the other hand, portfolio investment inflows in both short and long-term asset classes remain robust, assuming foreign investors continue their current search for yields. The recent upgrades in Indonesia's general credit rating and foreign and local-currency sovereign debt ratings by Standard & Poor's and Moody's should support these inflows.

Table 4: The BoP surplus is expected to narrow through the forecast window, as the current account moves into deficit ***(billions of USD)***

	2007	2008	2009	2010	2011
Balance of Payments	**12.7**	**-1.9**	**11.8**	**5.0**	**3.1**
Current Account	10.5	0.1	8.5	0.6	0.0
Trade Balance	*20.9*	*9.9*	*17.7*	*10.1*	*10.9*
Income Balance	*-15.5*	*-15.2*	*-14.0*	*-15.1*	*-16.7*
Transfers Balance	*5.1*	*5.4*	*4.8*	*5.6*	*5.8*
Capital & Financial Accounts	3.6	-1.9	4.7	4.4	3.1
Capital Account	0.5	0.3	0.2	0.3	0.3
Financial Account	3.0	-2.2	4.5	4.1	2.7
Direct Investment	*2.3*	*3.4*	*1.9*	*2.8*	*3.1*
Portfolio Investment	*5.6*	*1.7*	*7.1*	*6.5*	*5.0*
Other Investment	*-4.8*	*-7.3*	*-4.5*	*-5.2*	*-5.4*
Foreign Reserves (a)	**56.9**	**51.6**	**64.5**		

(a) 2009 foreign reserves value at end of November.
Sources: BI and World Bank projections.

Over the 12 months to Q3-2010, Indonesia's scheduled external financing obligations total USD 24 bn, based on BI reporting of the current stock of outstanding debt (Table 5). Over the same period, projections of trade and investment-related capital flows, plus net purchases of liquid financial assets (based on conservative assumptions), generate a projection of net inflows of around USD 29 bn. Combined, this gives a BoP surplus of around USD 5 bn, consistent with the projections presented in Table 4.

The assumptions underlying this projection are relatively conservative given recent trends. The 95 per cent roll-over rate on SBIs is lower than the realized rate through 2009, and allows for BI to reduce the stock of SBIs on issue. The 90 per cent roll-over rate on private short-term debt reflects still-recovering global credit conditions, plus the scaling back of some projects following the global downturn and lower commodity prices. These roll-over rates compare to the implied roll-over rates on total external debt, with more debt being issued than has fallen due through 2009 (Figure 23).

The volatility in Indonesia's financial markets and external capital flows remains a policy challenge

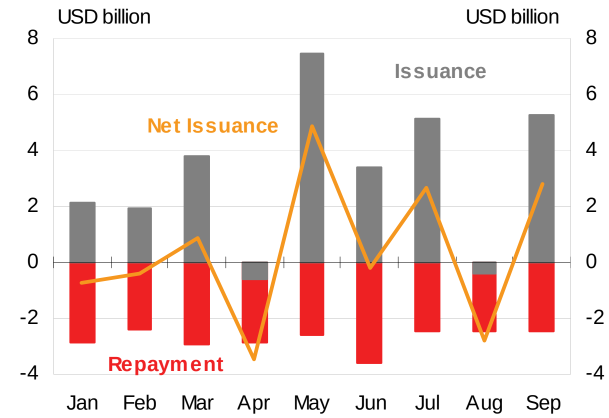
In late 2008, following capital outflows in September through November, policy makers and observers were concerned about the risk of larger capital outflows destabilizing Indonesia's macroeconomy. By late 2009, that concern has reversed, of the destabilizing impact of financial market volatility flowing from large inflows into liquid, high yielding financial assets. As two other major emerging markets (Brazil and Taiwan POC) introduced measures designed to slow the inflow of short-term capital, in mid-November BI announced it was "seriously considering" the implementation of capital controls on foreign ownership of one-month SBIs. However, by early December there has been no indication BI will apply such measures, with officials stating that: BI remained comfortable with the current policy; the inflows and outflows of foreign funds remained manageable; and these foreign flows did not cause any sharp fluctuations in the exchange rate. The vice-president stated that the government was not in favor of imposing capital controls on foreign investment flows. However, this public debate suggests that some policy change is more likely than has been the case for some time.

Table 5: Indonesia's currently scheduled external financing needs over the coming 12 months total USD 24 bn
(billions of USD)

EXTERNAL FINANCING NEEDS	**24.0**
Maturing short-term FCU private debt	8.7
Amortization of medium and long-term FCU debt	**9.4**
Public	6.8
Private (a)	2.6
Short-term IDR liabilities to non-residents	**5.3**
Amortization of medium and long-term IDR debt to non-residents	**.5**

Notes and source: (a) Excludes standstill debt of USD 6.5 bn. BI and World Bank.

Figure 23: Roll-over rates on Indonesia's external debt have also been high through 2009
(monthly principal repayments and issuances)



Sources: BI and World Bank

Table 6: Projected financing sources give a BOP surplus of around USD 5 bn
(billions of USD)

PROJECTED EXTERNAL FINANCING SOURCES	**28.7**
Current account balance	**-.3**
Trade balance	8.8
Net income and transfers balance	-9.2
Net FDI Inflows	**2.7**
Official Foreign Financing	**-.1**
Drawings	6.2
Repayments	-6.3
New Debt Issuances	**23.9**
Short-Term Debt Instruments	12.5
Public (SBIs) (a)	4.2
Private (notes)	8.4
IDR debt (b)	*.8*
FCU debt	*7.5*
o/w loans	*10.6*
o/w trade credits (c)	*-4.3*
Medium and Long-Term Bonds	11.4
Public (SUN)	4.9
Foreign investment in IDR bonds (d)	*1.4*
FCU bonds	*3.5*
Private (bonds)	6.5
Non-residents' net purchases of debt and equity on secondary markets (e)	**6.1**
Public (SUN and SBIs)	3.0
Private (debt and equity)	3.1
Net investment offshore by residents (f)	**-3.6**
o/w outflows on currency and deposits (f,g)	-.1

(a) assuming 95 per cent roll-over rate; (b) assuming 90 per cent roll-over rate; (c) expected to rise with increasing trade flows; (d) assuming 18 per cent foreign ownership of new SUN (government IDR bonds); (e) reflecting increasing net purchases of domestic assets by foreigners; (f) negative reflects outflow; and (g) reflecting residents shifting assets back from foreign bank accounts. World Bank projections.

While the external risks to the outlook have declined somewhat, risks from domestic developments have risen

There remains considerable uncertainty to the outlook. On the one hand, the risks to the global economy, while still considerable, appear to have been reduced. Recent outcomes have surprised on the upside, some international imbalances are stabilizing, and many economists have raised their forecasts, although the large recent capital flows and exchange rate movements create new risks, and the uncertainty surrounding the outlook for the global economy will increase when fiscal and monetary stimulus are withdrawn in the major economies.

On the other hand, the risks to the domestic outlook have increased. The increase in rolling blackouts in the Jakarta region and elsewhere in the country is likely to slow growth. The Jakarta region produces about 15 per cent of national output, so a small impact on activity in Jakarta can impact the national data. But these impacts are likely to be short-term, as the immediate cause of the increased blackouts around Jakarta is likely to be repaired before the end of Q4, while the national fast-track nationwide generation construction program appears to be near schedule. In addition, political developments since October have begun to raise some questions about the timing and depth of future reforms, with potential downside risks to growth.

Scenario analysis indicates a possible range of Indonesian GDP outcomes if these up- or down-side risks are realized. (Table 7 and Figure 24) The 'high growth scenario' provides for a faster recovery in the global economy, supporting accelerating export prices. This scenario also provides for stronger domestic conditions, with improved investor and consumer confidence accelerating credit, and capital inflows appreciating the rupiah. Under this scenario, GDP growth is 1¼ percentage points above the reference scenario presented above (Table 3).

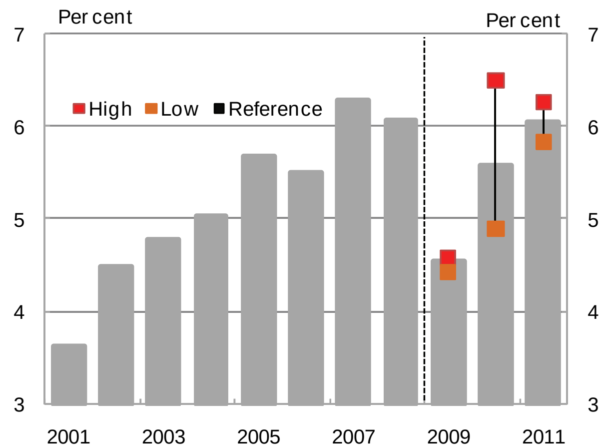
The 'low growth' scenario' assumes the impact of the recent rebound in trading partner growth and commodity prices is temporary, and that a weaker domestic investment climate weakens credit growth. This scenario subtracts up to 1 percentage points from GDP growth from 2009 to 2011 relative to the reference scenario.

Table 7: Alternative outcomes for key variables
(annual percentage growth; exchange rate level)

		MTP*	Credit	Export prices	Rupiah (USD/IDR)
2009	Reference	-0.9	15	1.2	10362
	Low	-1.0	14	0.9	10487
	High	-0.7	16	1.5	10362
2010	Reference	3.8	14	1.5	9500
	Low	2.2	10	1.0	11000
	High	5.5	19	9.4	8500
2011	Reference	3.9	23	7.5	9500
	Low	2.2	15	4.1	10000
	High	5.7	31	14.8	9000

* weighted average of major export destinations. Sources: CEIC, Consensus Forecasts Inc. and World Bank.

Figure 24: …have their greatest impact on 2010 growth
(annual percentage change)



Sources: BPS via CEIC and World Bank

4. The government's budget deficit is likely to be near target

a. Weaker-than-projected government revenue is offset by below-budget spending

Government revenues are weaker in line with nominal GDP, tax cuts and lower commodity prices and profits

Government revenues have continued to slow. Total central government revenues to the end of November 2009 were 18 per cent below the equivalent period in 2008 – in the year to July they had were down by 15 per cent. The further 3 percentage points of weakness reflect the ongoing impact of slower economic activity around the turn of 2009, the impact of the government's scheduled and stimulus tax cuts, and lower commodity prices and corporate profits. Together, these factors led to a fall in government revenues that has been sharper than the slowdown in nominal GDP growth.

Over 2009 as a whole, government revenues are likely to be 17 per cent weaker than in 2008. This is weaker than the projection made in September, reflecting weaker nominal GDP growth as prices have been weaker than expected, offsetting the impact of slightly stronger-than-expected growth in real GDP.

Spending in core government programs continued to be stronger than recent years, while subsidy spending in particular will be lower

The government spent 67 per cent of its personnel, materials, and capital budget by the end of October, compared with 60 per cent in the first ten months of 2008, despite the increased budget allocation to these three spending types. This improvement follows measures to accelerate disbursement of the overall budget and the stimulus package. For example, procurement can begin before the start of fiscal year, and unspent funds from 2008 were carried into 2009 to support the parliamentary and presidential elections, cash transfers program (BLT), PNPM programs, and some infrastructure projects. In addition, the thirteen month salary payment to government employees in June also contributed to improved government spending rates.
However, the rate of realized expenditure overall has been lower relative to the first 10 months of 2008, as lower spending on 'other' expenditures (which are mostly *ad hoc* items) and subsidies more than offset the improved spending rates on core government programs. In total, the central government has only spent 68 per cent of its revised budget

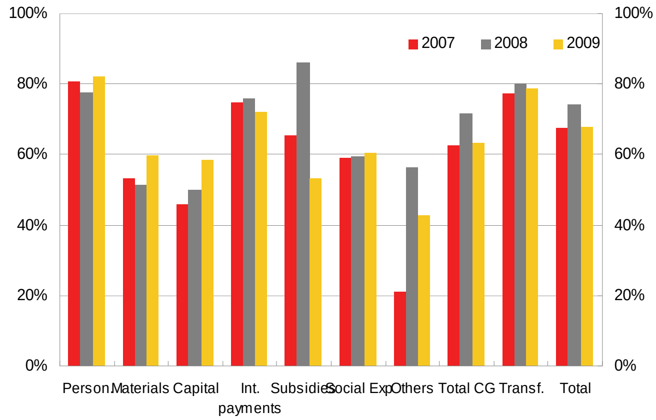
(APBN-P) by the end of October, 6 per cent less than in the same period of 2008. Lower international energy prices, tariff adjustments and the government's ongoing kerosene-to-LPG conversion program, and lower contingency budget spending (e.g., funds allocated to in case the economy diverges from projections) due to relatively supportive macroeconomic condition explain this weakness.

Less than half of the stimulus spending had disbursed by the end of October, although spending had accelerated

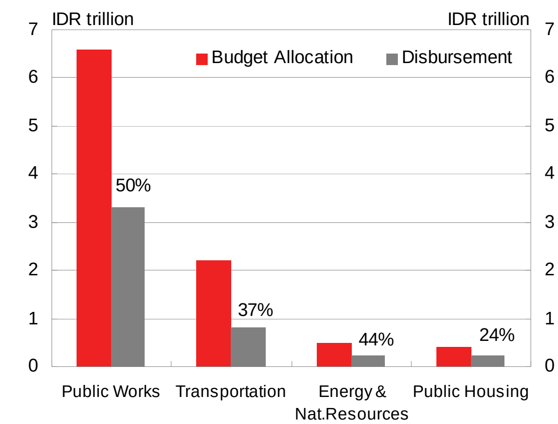
Less than half (42 per cent) of the government's IDR 11.5 trillion of stimulus spending had been disbursed by the end of October, although the rate of spending has accelerated (25 per cent had been spent at the start of the month). Bappenas has been monitoring disbursement closely. The Ministry of Public Work has spent half its allocation of 57 per cent of the stimulus spending, while other ministries receiving significant shares of the package (transportation, energy, and public housing) have only spent 35 per cent. The government reported that the programs funded by the stimulus spending have employed 754,000 people or 75 per cent of the 1 million people targeted.

Figure 25, Figure 26: Spending on core programs has improved compared with recent years, but lower spending on 'other' items and subsidies lowers overall spending

(budget realization as per cent of revised budget (APBN-P) by end October)



(actual stimulus spending of selected line ministries by end October)*



*These four line ministries represent 87 per cent of total stimulus spending. Sources: Ministry of Finance and World Bank staff estimates.

Spending in 2009 is likely to be slightly below budget, offsetting weaker revenues to give a budget deficit slightly less than planned

Spending to date and the projected economic environment for the rest of the year suggest that overall spending in 2009 is likely to be below the revised budget, largely because of weakness in subsidies and 'other' spending. (Table 8) This weakness is 4 per cent greater than had been projected in September, and partially offsets the weaker revenue projections. Together, these projections suggest a budget deficit near 2.3 per cent of GDP, 0.1 percentage points higher than previously estimated, and close to the government's revised estimate of 2.4 per cent.

Revenue growth in 2010 is expected to recover with stronger nominal GDP and no further planned tax cuts

In 2010, total revenue is expected to bounce back, growing by 15.9 per cent, broadly in line with the expected recovery in nominal GDP. Tax revenues, which typically map more closely with nominal GDP, are expected to grow by 16.2 per cent. Oil & gas income tax revenues are expected to remain relatively subdued, despite a higher oil price assumption, due to expectations of little production growth and higher cost recovery charges. Non-oil income tax, which continued to grow in 2009, is expected to show particular strength as corporate profits and personal incomes improve. VAT revenues are expected to bounce back after this year's unusual weakness (Box 1), growing by around 16 per cent following a recovery in consumption of taxable incomes. The higher oil price assumption is expected to have a larger impact on non-tax oil & gas revenues. (Table 9)

Table 8: Developments in revenue and spending
(central government revenue and spending)

	2006	2007	2008	To Nov 2009*	Explanation
	Annual percent change and percentage point contributions			YoY percentage point contrib's	
Tax revenue	**17.9**	**20.4**	**33.4**	**-8.0**	Cuts in tax rates, lower profits and formal wages with lower commodity prices and slower activity growth
Non-oil and gas	7.3	7.1	11.0	-4.3	Lower profits with lower commodity prices & demand; cuts in tax rates
Oil & Gas	2.3	0.5	6.4	1.5	Around a 50% fall in the international oil price; slightly lower production
VAT	6.3	7.8	11.1	-2.8	Less discretionary spending, partic. for goods subject to luxury tax rates
Land and building tax	1.3	0.7	0.4	-0.1	Slower investment
Duties on land and building transfer	-0.1	0.7	-0.1	0.1	Reduced economic activity
Excise	1.3	1.7	1.3	0.6	Slowing in consumption, offsetting the increase in cigarette excise rate
Other taxes	0.1	0.1	0.1	0.0	Slowing of economic activity
Import duties	-0.8	1.1	1.2	-0.8	Reduced import values with lower commodity prices and destocking
Export duties	0.2	0.8	1.9	-2.2	Lower commodity prices and weak export volumes
Non-tax revenue	**54.5**	**-5.2**	**49.1**	**-39.3**	Significant falls in oil prices
Oil	35.6	-13.9	35.0	-46.5	Around a 50 per cent fall in international oil prices
Gas	1.4	-0.8	5.3	9.0	Gas production remains steady
Mining	2.4	-0.4	1.4	-0.1	Lower prices and some weakening in volume demand reducing profits
Forestry	-0.6	-0.1	0.2	0.0	Slowing demand for woods and related products
Fishery	0.0	0.0	0.0	0.0	A small item where contributions to growth remain low
SOE transfer	6.9	0.1	2.7	-3.8	Reduced domestic demand reducing activity
Other	8.8	9.9	4.6	2.0	Lower fee collection through the slowing of domestic activity
Central gov't expenditure	**21.8**	**14.7**	**37.3**	**-11.2**	Growth in programmatic spending offset by a sharp decline in subsidies
Salaries	5.3	3.9	4.4	2.3	Growth in line with previous years' and streamlined 13th month salary
Goods and services	5.0	1.7	0.5	2.9	Increase in government consumption and early procurement
Capital	6.1	2.1	1.6	0.8	Planned government investment being spent earlier in the year
Social assistance	4.4	2.1	1.4	2.3	Growth in social expenditure and the BLT program
Others	1.0	-5.0	2.9	0.3	Election spending and increased 'planned expenditure'
Interest payments	3.8	0.2	1.7	3.6	In line with projections, with appreciation in IDR offsetting higher interest costs on new debt
Subsidies	-3.7	9.7	24.8	-23.4	Refined fuel prices have halved and the government continues to encourage less consumption of higher cost-energy

Notes and sources: * 2009 contributions relate to the first 11 months of 2009 relative to the same period in 2008. Central government expenditure data are to October 2009 only and so relate to the first 10 months. MoF, World Bank

The 2010 deficit target remains 1.6 per cent of GDP, a significant consolidation from 2009

The government approved the 2010 budget on September 30. The budget deficit has remained at the proposed 1.6 per cent of GDP, a significant consolidation from 2009's 2.3 to 2.4 per cent deficit. The composition of spending is broadly unchanged from the government's proposal, with total budgeted spending of IDR 1,046 trillion, 5 per cent more than budgeted for 2009. The energy subsidy is budgeted slightly above the proposed budget as the oil price assumption was raised to USD 65 per barrel. Personnel expenditure represents 15 per cent of planned spending, the same share as subsidies, while capital expenditure only receives 8 per cent of total budget.

The assumptions and projections presented in section 3 above imply a slightly larger budget deficit, at around 1.7 per cent of GDP for 2010. This partly follows slightly weaker revenues, largely due to the base effects of projected nominal GDP growth in 2009 being below the government's projection. Projected higher oil prices and ongoing improvements in the government's spending performance will potentially lead to higher overall spending than budgeted in 2010. But the current economic environment makes forecasting the magnitude and timing of the recovery in revenues unusually difficult, and a large amount of uncertainty surrounds the deficit projection.

Table 9: Small adjustments in the projected macroeconomic environment imply a slightly smaller budget deficit in 2009 and larger deficit in 2010

(central government revenue and spending, trillions of IDR)

	2007 Actual	2008 Actual	2009 Revised	2009 (f) WB estimate	2010 Budget	2010 (p) WB estimate
A. State Revenues and Grants	**707.8**	**981.6**	**871.0**	**814.5**	**949.7**	**943.6**
1. Tax Revenues	**491.0**	**658.7**	**652.0**	**619.8**	**742.7**	**720.3**
a. Domestic tax	**470.1**	**622.4**	**631.9**	**601.4**	**715.5**	**699.7**
i. Income tax	238.4	327.5	340.2	308.7	351.0	360.6
- Oil & gas	44.0	77.0	49.0	48.1	47.0	52.1
- Non oil & gas	194.4	250.5	291.2	260.6	303.9	308.5
ii. Other domestic tax	231.6	294.9	291.7	292.7	364.6	339.1
b. International trade tax	**20.9**	**36.3**	**20.0**	**18.4**	**27.2**	**20.7**
i. Import duties	16.7	22.8	18.6	17.8	19.6	19.4
ii.Export tax	4.2	13.6	1.4	0.6	7.6	1.2
2. Non tax receipts	**215.1**	**320.6**	**218.0**	**193.7**	**205.4**	**221.8**
o/w natural resources	132.9	224.5	138.7	110.8	132.0	137.1
i. Oil and Gas	124.8	211.6	127.7	100.2	120.5	125.3
ii. Non Oil & Gas	8.1	12.8	10.9	10.6	11.5	11.8
B. Expenditures	**757.7**	**985.7**	**1,000.8**	**942.9**	**1,047.7**	**1,054.3**
1. Central government	**504.6**	**693.4**	**691.5**	**641.0**	**725.2**	**738.0**
- Personnel	90.4	112.8	133.7	128.4	158.1	151.8
- Material expenditure	54.5	56.0	85.5	77.9	103.0	93.9
- Capital expenditure	64.3	72.8	73.4	71.9	83.2	81.5
- Interest payments	79.8	88.4	109.6	108.6	115.6	113.7
- Subsidies	150.2	275.3	158.1	142.8	157.8	191.1
- Grants expenditure	0.0	0.0	0.0	0.0	7.2	7.2
- Social expenditure	49.8	57.7	77.9	76.2	69.6	68.0
- Other expenditures	15.6	30.3	53.3	35.2	30.7	30.7
2. Transfers to the regions	253.0	292.4	309.3	301.9	322.4	316.3
C. Primary Balance	30.0	84.3	(21.3)	(19.9)	16.0	2.9
D. SURPLUS / DEFICIT	(49.8)	(4.1)	(129.8)	(128.5)	(98.0)	(110.7)
Deficit (per cent of GDP)	(1.3)	(0.1)	(2.4)	(2.3)	(1.6)	(1.7)
Economic assumptions/outcomes						
Gross domestic product	3,957.4	4,954.0	5,425.4	5,555.7	5,981.4	6,403.7
Economic Growth (%)	6.3	6.1	6.0	4.1	5.5	5.4
Inflation (%)	6.6	11.1	4.5	4.8	5.5	5.4
Exchange Rate (Rp/US$)	9,419	9,691	10,500	10,362	10,000	9,500
Crude-Oil Price (US$/Barrel)	78.0	97.0	61.0	60.9	65.0	79.0
Oil Production (barrel per day)	0.91	0.93	1.0	1.0	1.0	1.0
% of civil service wages increase	15.0	20.0	15.0	15.0	5.0	5.0
Interest rate of SBI (average %)	8.0	9.3	7.5	7.1	6.5	7.0

* 2009 contributions relate to the first 11 months of the year. Central government expenditure data are to October 2009 only. Sources: Ministry of Finance, World Bank

The government appears likely to have a financing surplus in 2009

Like 2008, the slightly less-than-projected deficit and the government's front-loaded financing strategy appear set to generate another financing surplus in 2009. (Table 10) The rupiah's appreciation has further reduced financing requirements. Even so, the government's financing needs in 2009, were still large, at around USD 22.5 bn, and in 2010 are likely to remain considerable, near USD 20 bn depending on the rate of nominal economic growth, the deficit and exchange rate movements. The budget passed at the end of September contained plans to fill about two-third of these needs from market sources, including through sales of *sukuk* (Islamic) bonds aimed at developing local Islamic finance markets. The government anticipates filling much of its remaining needs from official sources, while continuing to borrow less from official sources than it is repaying each year. These plans may change, as the budget financing plan made small use of the government's own funding sources, which may be larger than estimated at the time of preparing the budget given the estimated 2009 financing surplus. Further, the improvement in global financial market conditions means the government has not yet had need to call on the Public Expenditure Support Facility, and so the full resources of the facility will remain in place to support the government's financing should market conditions deteriorate again in 2010.

Table 10: Indonesia's 2010 financing needs remain considerable in 2010, although are likely to be supported by the government's likely 2009 financing surplus
(trillions of IDR unless otherwise indicated)

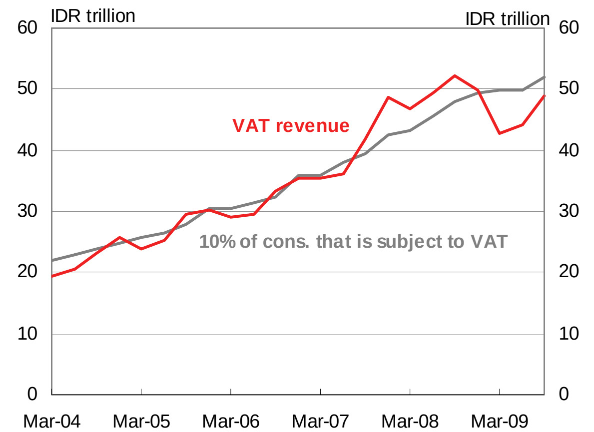
		2005	2006	2007	2008	2009		2010	
						APBN-P	WB	APBN	WB
Net financing needs:									
A	Primary deficit	-50.8	-49.9	-30.0	-84.3	20.3	19.9	-17.6	-2.9
B	Total interest payments	65.2	79.1	79.8	97.0	109.6	108.6	115.6	113.6
	of which:[1]								
	Total commercial bonds:	45.9	58.0	55.9	66.3	70.7	70.2	77.4	77.4
	Variable interest rate	18.2	22.8	14.4	15.3		10.9		8.9
	USD-denominated	1.9	3.6	4.9	8.9		12.0		11.0
	Official external loans	-37.1	-52.7	-57.9	-63.4	38.9	38.4	38.2	36.2
A+B	**Overall deficit:**	**14.4**	**29.1**	**49.8**	**12.7**	**129.8**	**128.5**	**98.0**	**110.7**
Amortizations:									
C	Commercial bonds [2]	19.7	23.6	34.4	40.6	37.2	37.2	37.1	37.1
D	Official external loans	12.3	13.6	19.6	25.4	69.0	68.1	58.8	55.9
C+D	**Total amortization:**	**32.0**	**37.2**	**54.0**	**66.0**	**106.2**	**105.3**	**96.0**	**93.0**
Gross financing needs:									
A+B+C+D	**Total gross financing needs:**	**46.4**	**66.3**	**103.9**	**78.7**	**236.0**	**233.8**	**194.0**	**203.8**
	(in billions of USD)	**4.8**	**7.3**	**11.3**	**8.1**	**22.5**	**22.6**	**19.4**	**21.4**
Financing sources: [3]									
	Official borrowing	28.1	26.1	34.1	50.2	69.3	*68.4*	57.6	
	Total commercial bonds:	22.6	36.0	57.2	85.9	142.4	144.1	141.6	
	IDR denominated						97.2		
	USD denominated						46.9		
	Domestic banking	-2.6	18.9	8.4	16.2	56.6	*56.6*	7.1	
	Other	6.6	3.1	2.7	2.9	3.1	*3.1*	1.2	
	Total gross financing sources:	**54.6**	**84.1**	**102.4**	**155.2**	**271.3**	**272.2**	**207.5**	
	(in billions of USD)	**5.6**	**9.2**	**11.2**	**15.9**	**25.8**	**26.3**	**20.7**	
Memo items:									
Variable interest rate (SBI-90 day rate)		9.16%	11.74%	8.04%	9.47%	7.50%	7.10%	6.50%	6.50%
Share of bonds at variable interest rate		31.9%	33.1%	28.6%	23.9%		21.6%		
IDR/USD exchange rate		9,751	9,141	9,164	9,757	10,500	10,366	10,000	9,500
Share USD bonds (prevailing exchange rate)		3.7%	6.9%	8.0%	11.8%		15.6%		

[1] Interest payments by component may not sum to totals due to different data sources, timing and rounding issues. [2] No USD bonds are due over this period.
[3] 2009 financing source projections in italics are taken from the APBN-P.
Sources: CEIC, Ministry of Finance, World Bank projections

Box 1: The economy's slowdown in late 2008 and 2009 has had a disproportionate impact on VAT revenues

After non-oil income tax, VAT is the second largest source of central government revenue, accounting for almost one-fifth of government revenues in recent years. In 2009, VAT revenues are likely to have fallen around 3.6 per cent from 2008, the largest fall in 40 years. The slowdown in real spending and stabilization in prices, particularly in contrast with the very rapid nominal growth of 2008 appears to have had a disproportionate impact on VAT revenues. For example, the relationship between notional consumption subject to VAT and VAT receipts has weakened, with VAT stronger than consumption in 2008 and weaker in 2009. (Figure 27) (Privation consumption subject to VAT is assumed to be all of non-food private consumption, and 20 per cent of food consumption, as most fresh foods are not subject to VAT; the actual number is likely to be smaller given that much retail activity is informal).

Figure 27: VAT revenues have become more volatile than consumption spending recently
(trillions of IDR)



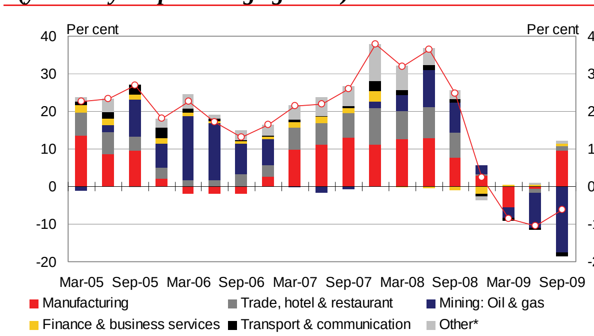
Sources: Ministry of Finance, BPS and World Bank

Stable prices and a weaker economy, especially in manufacturing, trade, hotels & restaurants and mining, seem to explain this fall in VAT. In times of an economic slowdown, consumers typically shift consumption away from discretionary items, which are generally taxable, towards personal savings or essential items such as basic food which are generally not subject to VAT, meaning that VAT collections can slow at a rate greater than the overall economy; the opposite is true in boom years. Nominal private consumption that is subject to VAT is expected to grow in 2009 by around 9 per cent, compared with 20 per cent in 2008, as the drop in inflation offsets a moderate acceleration in the real value of spending. The corresponding VAT category is likely to have shrunk 5.6 per cent in 2009, after increasing by over one-third in 2008.

The industries, and sources of VAT revenue, most affected by slowdowns in the economy also appears to be those more dependent on discretionary spending. (Figure 28, Figure 29) VAT from manufactured goods, and trade, hotels & restaurants has been particularly weak both in the final quarter of 2008 and early 2009, and in late 2005 and early 2006, when a large one-off increase in regulated fuel prices impacted disposable incomes and slowed real spending. VAT on imports and on domestic and imported luxury goods also led the weakness during these periods, and particularly strong during the peak of the recent cycle in the first part of 2008. (Q3 2009 VAT receipts are distorted by Pertamina's payments being reclassified from 'oil & gas mining' to 'manufacturing'.)

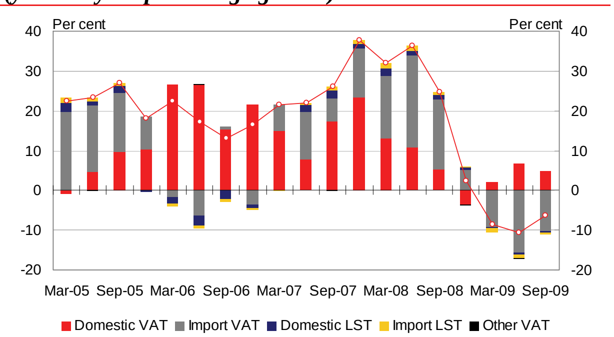
Over the coming years VAT revenues should bounce back slightly faster than the recovery in nominal GDP and private consumption, close the gap between VAT payments and the tax base in Figure 27.

Figure 28: VAT revenues from more industries producing more discretionary goods
(year-on-year percentage growth)



* 'Other' industries include agriculture, livestock and fishery, non-oil & gas mining:, quarrying, electricity, gas & water supply, construction, services and 'other'. Sources: Ministry of Finance, World Bank

Figure 29: ...were particularly weak during the slowdowns around the turn of 2009 and 2006
(year-on-year percentage growth)



Sources: Ministry of Finance, World Bank

B. SOME RECENT DEVELOPMENTS IN INDONESIA'S ECONOMY

1. Indonesia's trade flows through the global crisis: from peak to trough and back again

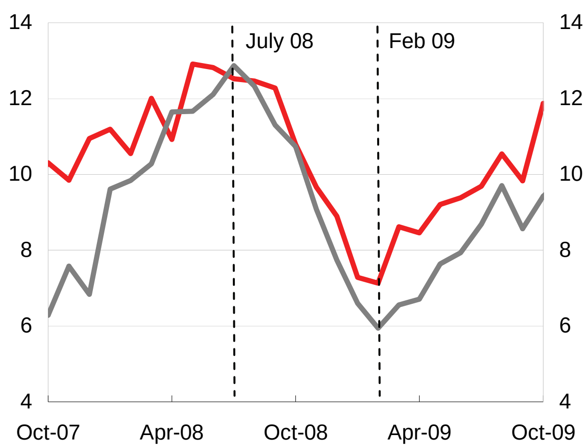
Indonesia's trade flows halved during the global economic crisis, mostly due to the slump in commodity prices

From July 2008 to February 2009, the value of Indonesia's merchandise exports fell by 43 per cent, while merchandise imports fell by 56 per cent. (Figure 30, Table 11) This slump, with the jump in volatility in financial markets and capital outflows, represented the greatest impact of the global economic downturn on the Indonesian economy. Indonesia's trade flows with all major trading partners fell during the period, with particularly significant falls in exports to Japan, Singapore and China. Import values also fell across all trading partners, as firms drew down inventories and the decline in exports reduced demand for imported inputs.

The collapse in oil and bulk commodity prices during this period explains most of the decline, while trade volumes remained relatively stable through late 2008 and early 2009. (Table 11) Compositional shifts contributed, too. Overall Indonesia's tradeables sector was not immune to the downturn in global demand – but lower commodity prices may have been sufficient to support higher demand for some goods in some markets, partially offsetting some of the negative impact of the global recession on Indonesia's trade flows.

Figure 30: Trade values peaked in mid-2008, and troughed in February 2009

(USD billions, non-seasonally adjusted)



Source: BPS

For exports, while retrenched demand saw large falls in mining and manufacturing volumes – particularly to Japan, Singapore and the US – oil & gas export volumes appear to have increased to Korea, and the volume of agricultural exports to China also rose (particularly in vegetable oils and palm oils). The contraction in export values to Japan was most severe, accounting for around a third of the total fall in export values – near Japan's export weight. This was predominantly due to lower prices for oil & gas exports, and lower prices and volumes of nickel exports. Contractions in export values to Singapore, China and the US also made significant subtractions. The fall in exports to the US and Singapore were due to lower volumes of textiles, clothing and footwear and chemicals, as well as lower prices and volumes in oil & gas and rubber exports, while the lower export values to China were driven by lower prices on rubber and oil products.

Similarly for imports, while investment-related capital and transportation volumes fell – particularly from Japan, China and Korea – price falls suggest that import volumes for lubricants from China and chemicals, transport and machinery from the US increased.

Table 11: Indonesia's imports fell further, and recovered faster, than exports
(per cent unless otherwise stated)

	July 2008 to February 2009				February 2009 to July 2009			
	Values Growth	Percentage point contribution due to prices	Percentage point contribution due to volumes	Proportion of total growth	Values Growth	Percentage point contribution due to prices	Percentage point contribution due to volumes	Proportion of total growth
Total Exports	**-43**	**-40**	**-3**	**100**	**36**	**-6**	**42**	**100**
Oil & Gas	-64	-82	17	34	45	45	0	18
Non-Oil & Gas	-37	-25	-12	66	34	-13	47	82
Agriculture	-34	-47	13	12	23	2	21	12
Mining & Minerals	-55	-17	-39	28	100	2	98	47
Forestry	-31	-27	-5	4	5	-3	8	1
Manufactured	-27	-17	-10	22	18	-27	44	22
Total Imports	**-56**	**-62**	**6**	**100**	**50**	**-7**	**58**	**100**
Consumer Goods	-41	-34	-7	3	53	-9	62	10
Intermediate	-57	-60	3	35	47	-29	76	15
Fuels and Lubricants	-73	-97	24	44	89	42	47	7
Transportation Goods	-50	25	-75	4	77	21	57	18
Capital Goods	-34	-3	-31	14	25	-16	41	50

Sources: BPS and World Bank

Categories that had been hardest hit in the downturn recovered fastest

By July, the value of Indonesia's exports and imports had grown by around 36 and 46 per cent, respectively. These gains were seen across all trade categories, but predominantly in oil & gas and mining commodities. Implied price movements suggest that much of the gain was in volumes, with a recovery in demand, in line with increasing investment and inventory restocking, both globally and in Indonesia, contributing significantly to the gain in trade values. It also suggests that only part of the recovery in global commodity prices has passed into Indonesia's exports and imports prices, with trade prices remaining subdued as further declines in electronics, machinery and capital goods prices more than offset gains in oil and bulk commodity prices. (Table 11)

With these price and volume developments, the recovery in export values has been driven by increasing mining & mineral and oil & gas exports to Japan, China and Korea. By August 2009, export values to China and Korea had returned to near pre crisis levels, in contrast to exports to Japan which remain about 40 per cent below their July 2008 level.

Table 12: While trade flows fell across the board, exports to the emerging economies in Indonesia's region have recovered faster
(USD millions and per cent)

	Exports					**Imports**				
	July 2008 Level	Contribution to Fall	Feb 2009 Level	Contribution to Rise	Aug 2009 Level	July 2008 Level	Contribution to Fall	Feb 2009 Level	Contribution to Rise	Aug 2009 Level
Japan	2,787	31	1,140	16	1,700	1,388	10	668	5	859
China	1,077	10	517	15	1,013	1,408	9	762	19	1,468
US	1,246	8	811	5	990	821	4	564	2	632
Singapore	1,376	11	781	-1	744	2,240	19	933	28	2,000
Korea	643	3	502	5	688	801	7	295	4	457
India	529	3	375	10	702	248	2	139	2	212
Malaysia	497	3	342	9	655	951	9	331	3	453
Australia	527	6	203	2	260	367	3	191	4	333
Other	3,845	26	2,464	39	3,793	4,645	37	2,057	33	3,293
Total	12,528	100	7,134	100	10,544	12,870	100	5,939	100	9,707

Sources: BPS and World Bank

2. The rupiah since late 2008: the scale of its movement and the driving factors

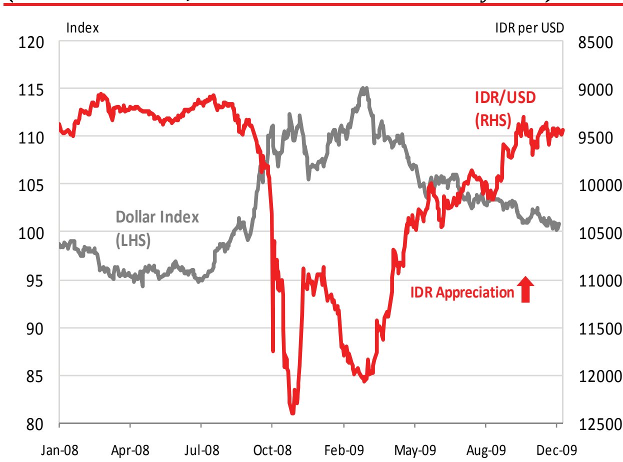
a. The rupiah has appreciated significantly since March, especially against the weakening US dollar

Since March the rupiah has appreciated significantly against the USD, to a lesser extent against other currencies

Since March 2009, the Indonesian rupiah has appreciated by 22 percent against the US Dollar (USD). (Table 13, Figure 31) The rupiah has also gained strength against other currencies (Table 13), with the real effective exchange rate (REER, a trade-weighted index of key rupiah bilateral exchange rates taking into account inflation) rising by over 16 percent during this period. (Figure 32) But the degree and pace of appreciation versus the USD has been particularly marked, raising concerns about its sustainability as well as impact on the real economy and competitiveness.

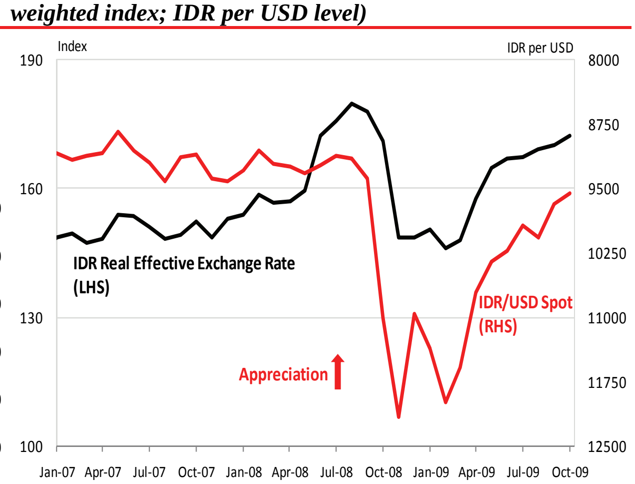
Inflows of foreign capital into Indonesian financial markets and the recovery in commodity prices appear to account for much of the rupiah's appreciation. In sum, a 1 percent increase in non-residents' investment in Indonesian financial assets is associated with a 0.62 per cent appreciation against the USD, holding commodity prices constant; and a 1 percent increase in non-oil export weighted commodity prices is associated with a 0.49 per cent appreciation, holding capital inflows constant. These factors together account for 73 per cent of the variation in the spot exchange rate between October 2008 and November 2009, and for almost 90 percent of the REER's movements over this period. (Table 14, Table 15) The relationship between these factors and the rise of the rupiah is developed below.

Figure 31: From March, the rupiah has nominally appreciated much more against the USD than the USD has weakened against a broad basket of currencies
(USD broad index, indexed to 100 on 21 January 1997)



Sources: Federal Reserve Board and BI via CEIC

Figure 32: Indonesia's exchange rate has also appreciated significantly in real terms against a basket of currencies
(real effective exchange rate based on JP Morgan trade weighted index; IDR per USD level)



Sources: JP Morgan and BI via CEIC

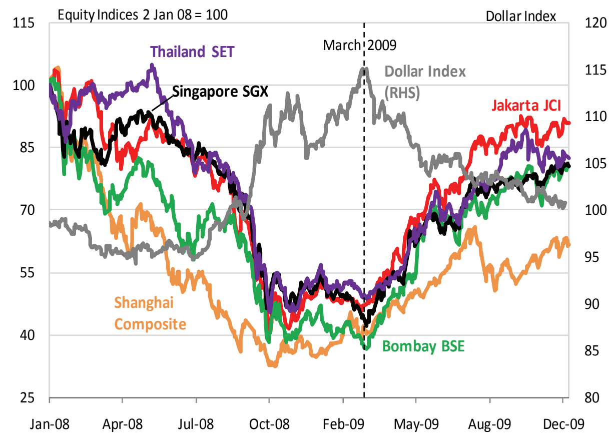
The FRB's broad USD index has weakened by 11.5 percent since March, while equities and emerging market assets and key commodity prices have rebounded strongly

The rupiah has not been the only currency to appreciate against the USD in recent months. The Federal Reserve Board's Broad Dollar Index (which includes 26 currencies representing America's major trading partners) has weakened by 11.5 percent since March, when global equity markets and asset prices in emerging market countries in particular started to rise (Table 13).

Moreover, the USD has exhibited a strong inverse relationship with the price of risky assets since the onset of the crisis last October. At the height of the crisis, when equities and asset prices crashed in late 2008 and then again in February-March 2009, the Dollar Index strengthened to its highest levels since 2005 as investors switched from risky assets to USD cash. But ever since asset markets began their recovery in the second quarter of 2009 and investors' risk appetite returned, the USD has depreciated substantially.

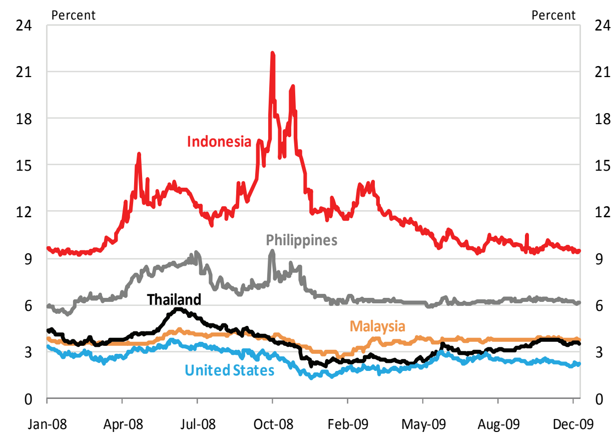
Since March, major Asian equity indices have gained over 80 percent on average. (Figure 33, Table 13) Furthermore, loose monetary policy has enabled bonds to perform well in emerging and developed economies: in Indonesia, 5 year local currency sovereign yields have dropped by 33 percent since March, while in developed nations such as the United States, central banks' quantitative easing programs have buttressed bond prices. (Figure 34) In addition, gold, which is seen by investors as an inflation hedge as well as alternative currency, and which has historically had an inverse correlation with the USD, has risen by 20 percent since March to historical peaks in nominal terms.

Figure 33: The USD Index has moved in the opposite direction to global stock indices since the onset of financial market turmoil in September 2008
(equity market indices, indexed to 100 on 2 January 2008)



Sources: CEIC and World Bank

Figure 34: Indonesian local currency bond yields have fallen by one-third since March, but remain well above yields elsewhere
(5 year local currency sovereign bond yields in per cent)



Source: CEIC

The IDR/USD exchange rate became highly correlated with the USD index from September 2008, with movements in the USD index coinciding with larger than proportionate movements in the IDR/USD rate

The IDR/USD exchange rate has moved closely with the Dollar Index since late 2008 (ie, the rupiah has gained strength as the Dollar Index has weakened, and vice-versa), with movements in the Index tending to be associated with greater than proportionate movements in the IDR/USD exchange rate, especially since the onset of the crisis. The correlation between movements in IDR/USD and the Dollar Index is 68 per cent from January 2007 to November 2009, but strengthens to **92 per cent** if we isolate the period from September 2008 to the present. In addition, regression analysis for January 2007-November 2009 indicates that a 1 percent increase in the Dollar Index is associated with a 1.22 percent depreciation of IDR/USD. Narrowing the timeframe to September 2008-November 2009 strengthens this association to a 2.1 percent depreciation of the rupiah for every 1 percent gain of the Dollar Index. Both results are statistically significant at a high level and appear robust. (Table 14)

b. Inflows of capital into liquid financial assets explain much of the appreciation…

USD weakness, historically low interest rates in the US and strengthening emerging markets have led to large capital inflows into emerging economies

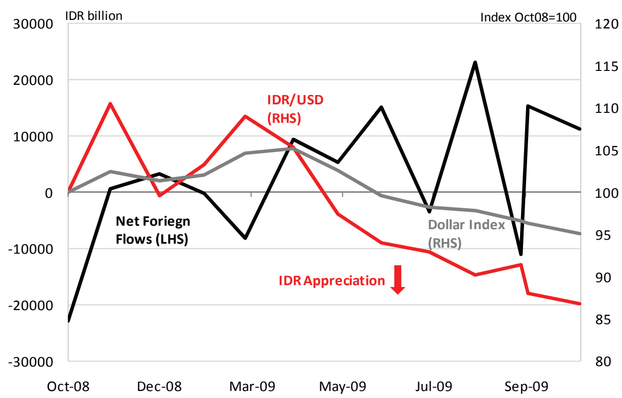
The combination of low interest rates in the United States, the weakening USD, and strengthening asset prices in emerging markets has led to a huge inflow of capital into emerging economies with open capital accounts in the past six months. Investors have put on carry trades, borrowing in USD to buy higher yielding assets in emerging markets — at effectively negative interest rates. This has added pressure on emerging market asset prices and currencies, leading some commentators to suggest that asset prices have risen by more than is justified by improving economic fundamentals.

Indonesia has attracted capital inflows of USD 6.5 billion since March, which correlate closely with the rupiah's appreciation

Indonesia, with its highly attractive interest rate differentials and open capital markets, has drawn significant inflows of non-residents' capital. (Figure 35) Since March 2009, the country has absorbed USD 6.5 billion in net foreign inflows, 40 per cent of this in September and October. (Figure 36)

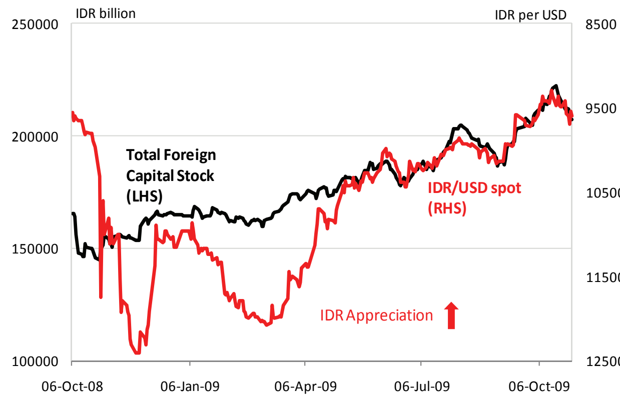
Without full sterilization by the central bank (building its foreign exchange reserves and offsetting the impact on the domestic economy), such inflows inherently cause a short-run appreciation of the exchange rate. The correlation between the IDR/USD rate and the total stock of non-residents' holdings is 70 per cent between October 2008 and November 2009 (ie, the rupiah appreciates when the foreign capital stock increases), with a 1 per cent increase in the stock of foreign capital associated with a 0.53 percent appreciation of IDR/USD. (Table 14, Figure 36) Since the total stock of foreign capital in Indonesia has increased by about 28 percent since March (with September and October accounting for 9 percentage points of the increase), capital inflows have contributed significantly to the rupiah's appreciation over this period.

Figure 35: There have been significant net capital inflows into Indonesia since March…
(net flows in IDR billion; USD Index and IDR/USD indexed to 100 in October 2008)



Sources: Federal Reserve Board, CEIC, BI and World Bank

Figure 36: …increasing the stock of foreign capital held in Indonesia by USD 6.5 billion – over one-quarter
(non-residents' holdings of equities, government IDR bonds and short-term money market instruments)



Sources: : Federal Reserve Board, CEIC, BI and World Bank

Non-residents' investment in Indonesian financial assets is inversely correlated with USD strength, interest rate differentials, and Indonesian EMBI spreads …when risk increases, foreigners cut their Indonesian holdings

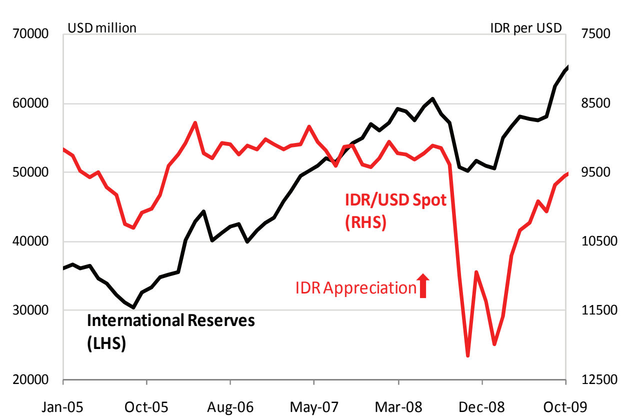
Among the factors driving inflows, the stock of foreign capital shows an 80 per cent inverse correlation with both the Dollar Index and interest rate differentials between Indonesia and the US. Regression analysis indicates that a 1 per cent increase in the Dollar Index is associated with a -1.34 per cent decrease in the foreign capital stock, holding interest rates constant. Similarly, a 1 per cent increase in interest rate differentials (between 3-month Indonesian SBIs and 3-month US T-Bills) is associated with a 0.62 per cent reduction in the foreign capital stock, holding the Dollar Index constant. (Table 14)

While it may seem counterintuitive that an increase in interest rate differentials is associated with a decline rather than an increase in foreign capital stock, this may reflect baseline differences between Indonesian and US rates being so high that any further increase in differentials is usually due to a negative shock or rise in perceived Indonesian risk and therefore coincides with a decrease in non-residents holdings. The total stock of foreign capital in Indonesia has a 95 per cent negative correlation with Indonesian EMBI spreads, which are often used as a proxy for country risk (Figure 38): a 1 per cent increase in EMBI spreads is associated with a 0.23 per cent decline in the stock of foreign capital. So when spreads and country risk increase, money flows out. (These spreads are also highly positively correlated with the Dollar Index and interest rate differentials.)

Indonesia remains particularly vulnerable to hot money inflows as the flows tend to be volatile and can leave rapidly, disrupting financial markets and the economy

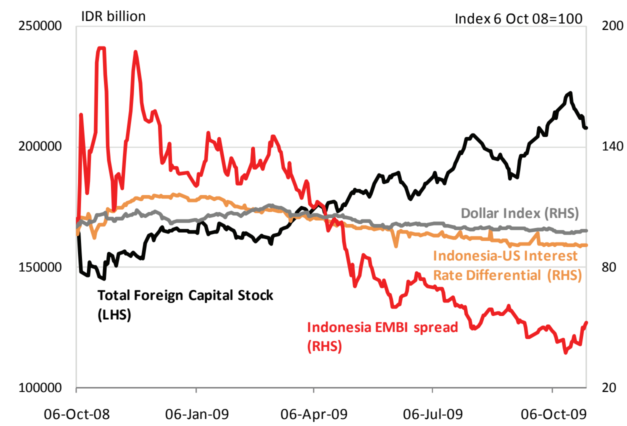
While the speed and volume of capital inflows into liquid Indonesian financial assets has not been dissimilar to other emerging market countries in Asia and Latin America, the archipelago remains particularly vulnerable to this 'hot money'. First, the country has completely open capital markets, more so than its neighbors, and has thus far remained committed to not imposing capital controls. Second, the legacy of the 1997-98 crisis makes investors in Indonesia particularly liable to shift large amounts of funds for reasons that may be tenuously related to fundamentals (as indicated by the highly negative correlation between EMBI spreads, indicating perceived country risk, and the stock of non-residents' holdings). To the extent that money flows out of the country as quickly as it flows in, and trading volumes on Indonesia's financial markets remain relatively thin, hot money flows can significantly add to market volatility, with wider impacts on investor confidence, the exchange rate, and the real economy. Intervention by policy makers can limit the impact of these flows, but most policy options are costly. (Figure 39)

Figure 37: Indonesia's foreign reserves have been correlated with the exchange rate since October 2008, suggesting BI has been partially limiting the exchange rate's volatility *(reserves in millions of USD, IDR/USD exchange rate level)*



Sources: BI via CEIC and World Bank

Figure 38: Non-residents' holdings of Indonesian financial assets has fallen when country risk rises, and vice versa *(foreigner's stock of Indonesian financial assets in billions of IDR; Dollar Index, EMBI spread and interest rate differential indexed to 100 on 6 October 2008)*



Sources: Federal Reserve Board, CEIC, BI and World Bank

Figure 39: Monetary and fiscal policy can limit the impact of capital inflows, but most options are costly

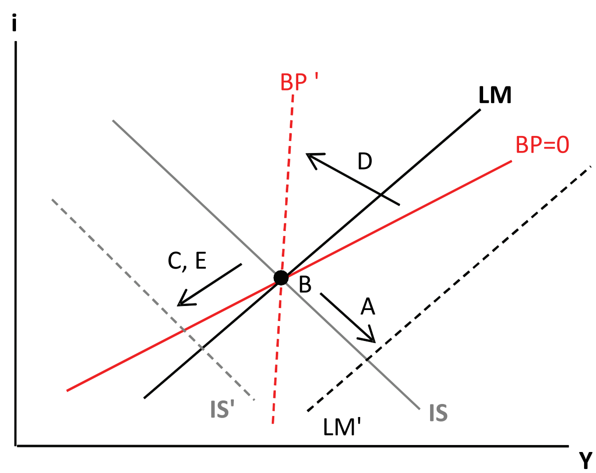
A : Allow inflow of money (*shifts LM right*) → Can be inflationary

B : Sterilize inflow by building reserves, OMO (*stay at B*) → Can prolong inflows by keeping interest rates high

C : Allow appreciation (*shifts IS and BP left*) → Exports lose competitiveness

D : Impose capital controls (*moves BP upward, steeper slope*) → Lose efficiency; have to finance investment through higher cost domestic funds rather than borrowing from abroad at lower cost

E : Fiscal contraction (*shifts IS left*) → Can be recessionary; politically difficult



The IS-LM model is a Keynesian framework that focuses on the interaction between the real and monetary elements of the economy. The IS (investment-savings) curve represents the relationship between output and interest rates that gives equilibrium in the goods market, while the LM (liquidity preferences and money supply) curve represents the relationship between income and interest rates that gives equilibrium in the money market.

c. ...with the recovery in commodity prices fuelling strength as well

Since commodities make up much of Indonesia's exports, the rupiah tends to strengthen with commodity prices

Commodity prices are a second important channel through which USD weakness impacts the IDR/USD exchange rate. The USD Index bears a strong inverse correlation with commodity prices: a 1 per cent increase in the Index is associated with a 4.2 per cent decrease in Indonesia's non-oil export-weighted commodity price index. (Table 14) Commodities account for more than half of Indonesia's total exports. Empirical studies by Rogoff and Chen (2003) have found a significant correlation between real exchange rates and the world price of the commodity exports of Australia, Canada and New Zealand—three countries where primary commodities constitute a major component of exports.

A similar relationship seems to exist in Indonesia between USD export-weighted commodity price indices (EWCPI) and both the spot and real effective exchange rates. (Figure 40, Figure 41) The spot exchange rate exhibits an inverse correlation of 69 per cent with the oil- and non-oil EWCPIs (ie, the rupiah appreciates when commodity prices rise). A 1 per cent increase in the non-oil EWCPI is associated with a 0.26 per cent appreciation of IDR/USD (the appreciation is 0.25 per cent for oil EWCPI). The correlation and regression results are even stronger for the REER. The non-oil EWCPI shows an 88 per cent correlation with the real exchange rate, and a 1 per cent increase in the index is associated with a 0.46 per cent appreciation (the relationship is similar for oil EWCPI). (Table 14, Table 15)

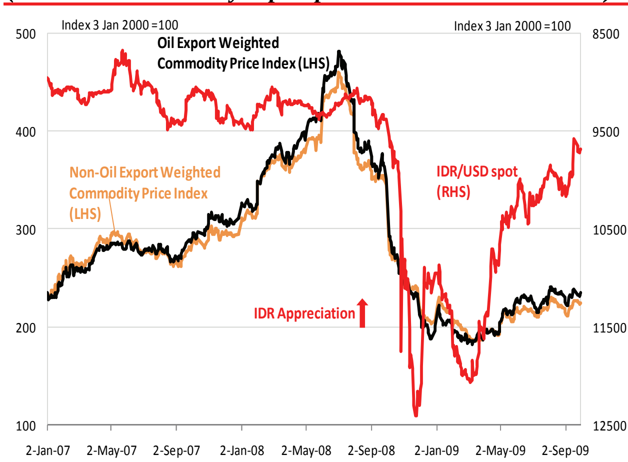
These results suggest that the recent weakness of the Dollar Index has filtered into higher commodity prices, and given the positive correlation between the rupiah and commodity prices, this has been another channel through which IDR/USD has appreciated.

Table 13: Movements in exchange rates and asset prices since September 2008

	Level Sep 2 2008	March 2009 High	Level Nov 9 2009	%Change since March	%Change since Sep 08
IDR Crosses					
IDR/USD	9192	12065	9420	-22	2.5
IDR/EUR	13407	16130	14040	-13	5
IDR/GBP	16463	17119	15705	-8	-5
IDR/SGD	6437	7837	6778	-13.5	5
IDR/AUD	7808	8187	8712	6.4	11.5
USD Crosses					
INR/USD	44.4	51.8	46.36	-10.5	4
SGD/USD	1.4308	1.5565	1.3862	-11	-3
KRW/USD	1134.45	1570.1	1154.6	-26	2
JPY/USD	108.85	97.17	89.92	-7.5	-17
USD/AUD	0.8360	0.6301	0.9293	47	11
USD/EUR	1.4522	1.2580	1.4999	19	3
Dollar Index	99.83	115	101.9	-11.4	2
Stock Indices					
Jakarta	2159	1256	2406	92	11
Bombay	7861	4160	8703	109	11
Shanghai	2305	2071	3175	53	38
Singapore	2759	1456	2693	85	-2
Thailand	659	413	713	73	8
5yr IDR Govt Bond Yield	12	14	9.35	-33	-22
Gold Price ($/troy oz)	798	890	1062	20	33

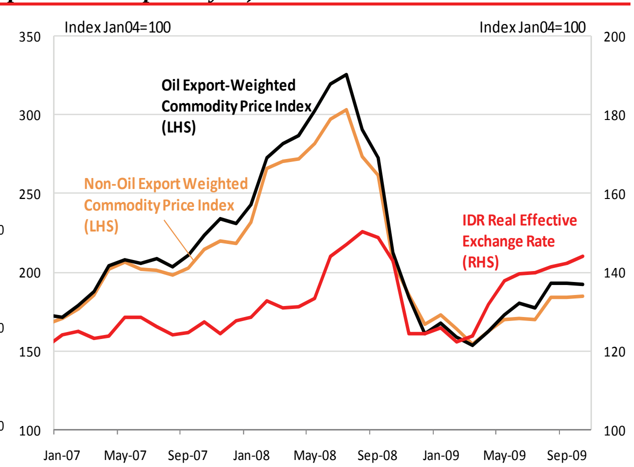
Source: CEIC and World Bank

Figure 40: Movements in commodity prices are correlated with movements in the rupiah, reflecting the importance of commodities in Indonesia's exports basket
(Indonesian commodity export prices indexed to 100 in 2000)



Sources: BI via CEIC and World Bank

Figure 41: …and the relationship is particularly strong against the real effective exchange rate
(USD broad dollar indexed to 100 on 21 January 1997; gold price in USD per troy oz)



Sources: Federal Reserve Board, CEIC, BI and World Bank

The Australian dollar, with similar characteristics to the rupiah, has strengthened by even more since March

Many of the characteristics that appear to have supported the rupiah are shared buy the Australian dollar (AUD), despite the two economies' substantial differences in income and institutional development. Both economies have open capital accounts, domestic interest rates significantly higher than global rates, and a large share of commodities in their export baskets. Both have appreciated considerably against the USD and other currencies this year: the AUD has appreciated by 47 per cent against the USD since March, twice as much as the rupiah. (Table 13)

Table 14: Regression analysis of the rupiah exchange rate and some of its key correlates
(regressions on daily data)

Independent Variable	Time Period	Coefficient	R Square	T-Statistic
Dependent Variable: Log IDR/USD spot				
(1) Log FRB Dollar Index	Jan 07 - Nov 09	1.229	0.47	24.1
(2) Log FRB Dollar Index	Sep 08 - Nov 09	2.108	0.85	38.9
(3) Log Foreign Capital Stock	Oct 08 - Nov 09	-0.535	0.49	-16.0
(4) Log Non-Oil Export Weighted CPI	Jan 07 - Oct 09	-0.261	0.47	-24.5
(5) Log Oil Export Weighted CPI	Jan 07 - Oct 09	-0.246	0.48	-24.7
(6) Log Indo EMBI Spread	Oct 08 - Nov 09	0.148	0.66	21.9
(7) Log Interest Rate Differential	Oct 08 - Nov 09	0.833	0.70	24.4
(8) Log Foreign Capital Stock	Oct 08 - Nov 09	-0.621	0.73	-21.1
Log Non-Oil Export Weighted CPI	Oct 08 - Nov 09	-0.486	0.73	-17.1
Dependent Variable: Log Foreign Capital Stock				
(1) Log FRB Dollar Index	Oct 08 - Nov 09	-2.506	0.65	-21.5
(2) Log Indo EMBI Spread	Oct 08 - Nov 09	-0.228	0.91	-50.4
(3) Log FRB Dollar Index	Oct 08 - Nov 09	-0.619	0.73	-8.9
Log Interest Rate Differential	Oct 08 - Nov 09	-1.335	0.73	-8.1
Dependent Variable: Log Indo EMBI Spread				
(1) Log FRB Dollar Index	Oct 08 - Nov 09	11.547	0.78	30.1
Dependent Variable: Log FRB Dollar Index				
(1) Log Non-Oil Export Weighted CPI	Jan 07 - Oct 09	-0.183	0.76	-45.7
Dependent Variable: Log Non-Oil Export Weighted Commodity Price Index				
(1) Log FRB Dollar Index	Jan 07 - Oct 09	-4.171	0.76	-45.7

Source: World Bank

Table 15: …and of the correlates of the real effective exchange rate
(regressions on monthly data)

Independent Variable	Time Period	Coefficient	R Square	T-Statistic
Dependent Variable: Log REER				
(1) Log Non-Oil Export Weighted CPI	Jan 04 - Oct 09	0.458	0.77	15.2
(2) Log Oil Export Weighted CPI	Jan 04 - Oct 09	0.446	0.73	13.6
(3) Log Net Foreign Assets	Jan 04 - Aug 09	0.418	0.82	17.3
(4) Log Non-Oil Export Weighted CPI	Jan 04 - Aug 09	0.227	0.89	6.2
Log Net Foreign Assets	Jan 04 - Aug 09	0.251	0.89	7.6

Source: World Bank

C. INDONESIA 2014 AND BEYOND: A SELECTIVE LOOK

1. Seeing Indonesia as a middle-income country

A decade after a twin crisis, Indonesia is now an emerging confident middle-income country …

As the first decade of the 21st century draws to a close, Indonesia has emerged as a middle-income economy, economically strong, politically stable, and with increasing confidence and global standing. This was unexpected a decade ago, when Indonesia experienced a severe economic crisis that resulted in the economic dislocation of millions of households, a sharp rise in poverty, a 13 percent decline in GDP, and near bankruptcy of the financial sector. The economic crisis triggered a dismantling of the previous political order, leading to a period of political turmoil characterized by several changes in government and the heightening of separatist tensions.

… with fundamental structural changes ahead

Over the past decade, Indonesia's fiscal and political systems have been transformed. Perhaps less mentioned, but ultimately just as important, Indonesia is also in the midst of a fundamental demographic and geographic shift. Indonesia is now an urban country with more than 50 percent of the population living in urban areas. Within the next five years, Indonesia will have a population of 250 million people, almost 60 percent of whom will live in cities. At the same time, with declining fertility rates and with the fraction of elderly yet to rise sharply, Indonesia will continue to enjoy a "demographic dividend" in the next decade as the working age population increases relative to the rest of the population.

…and the potential to rise further into the ranks of dynamic, inclusive middle-income economies

Because of Indonesia's achievements in the past decade, it is now possible to imagine a new Indonesia emerging in the decade ahead: an Indonesia in which every child receives a quality primary education and goes on to complete secondary education; an Indonesia where highways connecting Surabaya with Jakarta and Medan provide market access and an economic lifeline to the towns and villages along the way; an Indonesia that is globally competitive not just in the commodity-based sectors where it has a natural resource advantage but also in selected manufacturing and service industries; and an Indonesia where all Indonesians enjoy affordable access to quality health services. If Indonesia is able to build on the robust foundation of macroeconomic and political stability it has established thus far and accelerate growth while ensuring that growth is shared and is sustainable, it has the potential to become a dynamic, competitive and inclusive middle-income country in the decade ahead.

Much remains to be done, however, to realize this potential …

However, to realize the vision and potential of a rising Indonesia, much remains to be done. Growth has restarted and has been robust, but infrastructure continues to be poor and the investment climate remains weak. Higher levels of growth have not translated, to the extent hoped for, into greater poverty reduction, and a large percentage of the population remains vulnerable to poverty. On the employment front, there are positive signs of a turnaround in the last five years, but Indonesia still lags behind its more prosperous neighbors in creating higher value-added non-agricultural jobs. Because of geographic and income-related disparities and the poor quality of health, water and sanitation and education service delivery at the local level, Indonesia's performance in terms of human development outcomes has been quite uneven over the last decade despite significant increases in public expenditures. There is considerable evidence as well that Indonesia's environmental quality is deteriorating and its natural resources being unsustainably depleted.

…and the task will not be easy and it will take time

Against the background of a strong fiscal position, the next five years provide an opportunity for Indonesia to address these structural weaknesses. But the task will not be easy and it will take time. Democratization and decentralization have fundamentally changed accountability structures and decision-making processes within government. These changes have highlighted systemic weaknesses in the processes and capacity for formulating and implementing policy and have made the process of implementing reforms a more challenging and time-consuming task. Government effectiveness has been limited by insufficient capacity and accountability of civil servants and by coordination problems within government. Because highly competitive elections have led to coalitional politics at the national level and in many regions, and greater voice in the political arena has been afforded to a wide range of non-state actors, the task of reaching consensus on critical policies and reforms has become that much more challenging. Decentralization has changed accountability structures or weakened them, as the division of roles and responsibilities between the various levels of government remains unclear in many spheres of government activity. At the same time, the tasks Indonesia faces, as an emerging middle-income economy, have become more difficult, in part because of its own past successes and in part because the global economic environment is rapidly changing.

An opportune moment to take on the task, at the threshold of a new decade, with a new government and a new five-year plan

But this is a particularly opportune moment for Indonesia to tackle this task. Having weathered the global downturn well, Indonesia is now much better positioned than most middle-income economies to think more proactively about development policy and spending priorities for the next five years and beyond. The newly reelected government will have the opportunity to implement an ambitious development program. In particular, the National Medium-Term Development Plan (RPJM) for 2010-2014, which is currently being finalized and will be submitted for parliamentary approval early in 2010, provides the government a crucial opportunity to shape Indonesia's development prospects for the next five years and lay the foundations for the remainder of the coming decade. The government will face important policy and public expenditure choices. The institutional and policy reforms Indonesia prioritizes, the amount of resources it chooses to spend on development, where it chooses to spend these resources and how effectively it implements its development programs will substantially influence Indonesia's longer-term economic and social prospects.

A selective look at Indonesia's development priorities and challenges

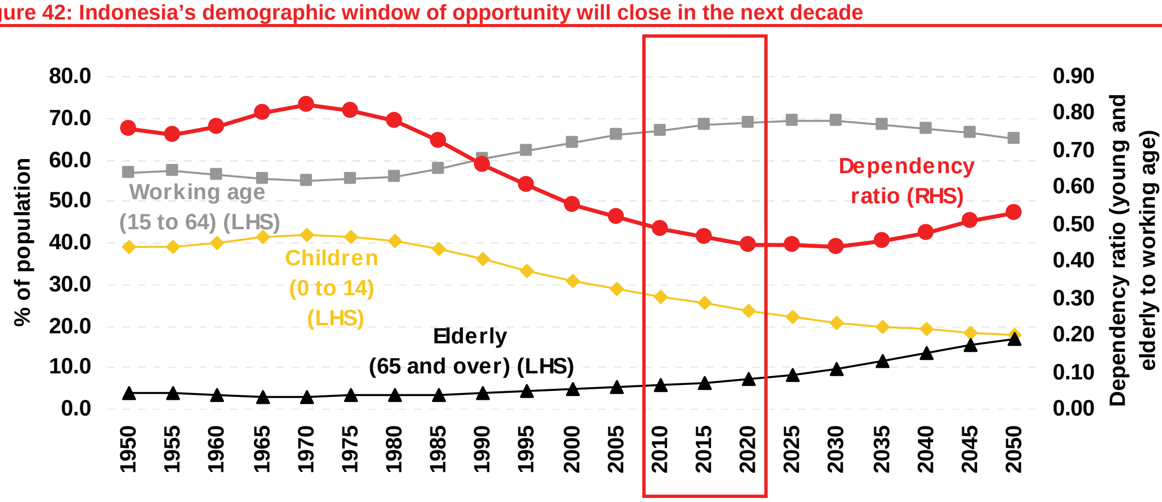
To contribute to and inform the public discussion about these important choices, this edition and this part of the Indonesia Economic Quarterly begins a selective look at Indonesia's development prospects, priorities and challenges in the next five years and beyond. It does so by drawing on recently completed, forthcoming and ongoing analytic work undertaken by the World Bank to present salient facts and analyses on selected topics relevant for thinking about Indonesia's medium-term development priorities and challenges. In this edition, the focus is on the demographic trends Indonesia will confront in the coming decade and the challenges and opportunities that these present in terms of creating jobs and financing healthcare.

2. Indonesia is entering a demographically critical decade

Indonesia has enjoyed a demographic dividend in the last forty years…

For the last forty years Indonesia has enjoyed a kind of demographic dividend as declines in fertility have reduced the fraction of children (ages 0 to 14) in the population without a corresponding increase in the fraction of elderly (ages 65 and over). And as a result, the dependency ratio—the ratio of children and elderly (i.e., dependents) to the working-age population—has steadily declined from over 0.8 in 1970 to about 0.5 in 2009 (Figure 42).

Figure 42: Indonesia's demographic window of opportunity will close in the next decade



Sources: Demographic projections from BPS and UN Statistics.

…but this demographic window of opportunity will close in the next decade

But this demographic window of opportunity will close in the next decade. Sometime between 2020 and 2025 Indonesia's dependency ratio will begin to rise again. And it will do so because the fraction of elderly in the population will begin to rise sharply, offsetting both the decline in the share of children as well as the increases in the working-age population. In the coming decade the number of Indonesians over the age of 65 is expected to increase by about 4 million, roughly the number by which it increased in the last decade. However, between 2020 and 2030, the number of elderly will rise by 8 million, and by 2030 the fraction of elderly in Indonesia's population is projected to be around 10%. From a demographic perspective, therefore, the next decade will be critical for Indonesia.

3. Creating better jobs for Indonesia's growing labor force

Indonesia's window of demographic opportunity also creates a challenge to create many new, better quality jobs

Indonesia's working-age population will grow in size by about 20 million over the next decade, or about 2 million per year. To make the most of its remaining demographic window of opportunity Indonesia will need to generate a large flow of new, good quality jobs.

The World Bank's forthcoming *Indonesia Jobs Report*, scheduled for release in early 2010, reviews the main trends in Indonesia's labor markets over the last two decades, will provide further ideas for how labor policies and programs can encourage job creation and better prepare disadvantaged workers to succeed in the labor market. The following paragraphs summarize some of the basic trends and developments in the Indonesian labor market described in the *Report*.

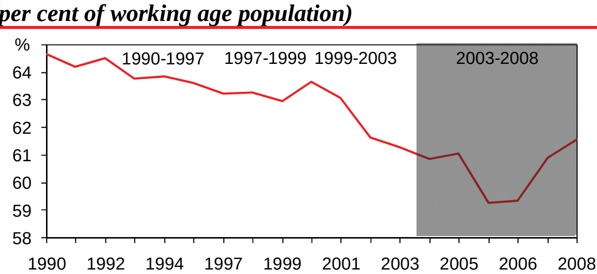
Accelerating poverty reduction depends on the creation of more jobs

Labor is one of the few assets of the poor. If provided with a good job, they have a chance to earn their way out of poverty. Indonesia experienced jobless growth from 1999 until 2003, which slowed down the rate of poverty reduction. The uneven performance of the labor market in Indonesia continues to raise concerns whether Indonesia is at risk of falling into a situation of jobless growth again. To ensure that the benefits of growth are be shared more broadly, economic growth must translate into more jobs.

Employment trends are improving but job creation is remains moderate

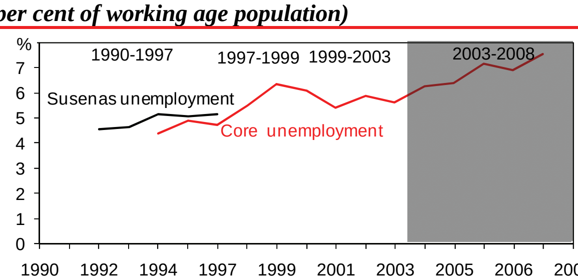
The employment rate, after falling for six years, is turning around and has been on an upward trend since 2006. More recently, the rate increased from 61.5 percent in August 2008 to 62.1 percent in August 2009. Employment gains have strongest among female workers, as well as rural and young workers. The core unemployment rate has stabilized during recent years and actually decreased from 8.39 percent in August 2008 to 7.87 percent in August 2009. Although an encouraging sign, stable unemployment rates can mask problems in the labor market if workers are being pushed into jobs that are less secure or provide poorer conditions. It is necessary, therefore, to also examine some indicators of the quality of employment.

Figure 43: Rising employment
(per cent of working age population)



Sources: Sakernas and World Bank

Figure 44: Stabilized unemployment
(per cent of working age population)

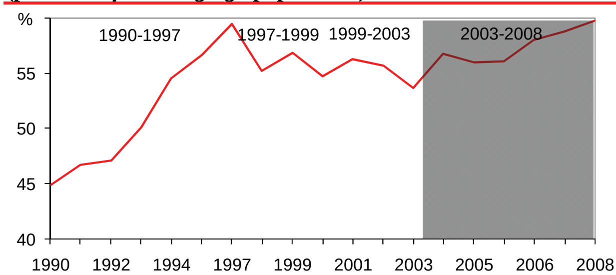


Sources: Sakernas and World Bank

The creation of 'better' jobs has leveled off

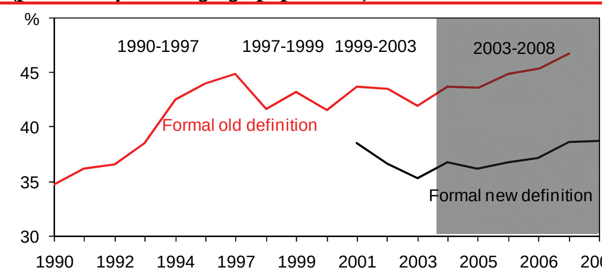
Two main indicators for the quality of employment are the share of active workers employed in the non-agricultural and in the formal sectors. Formal sector jobs are considered 'better' because regular salaries provide employees with more income security and they are entitled to additional benefits legislated by the Manpower Law (No. 13/2003). Similarly, non-agricultural jobs are more productive and offer higher wage premiums for workers. Despite Indonesia's economic recovery during 1999-2003, formal sectoral employment fell and workers were pushed into agricultural jobs. The quality of employment, however, has been gradually improving since 2003. Recent formal and non-agricultural job creation has stagnated, increasing by 0.22 and 0.63 percentage points, respectively, from August 2008 to August 2009.

Figure 45: Slow formal sector employment growth
(per cent of working age population)



Sources: Sakernas and World Bank

Figure 46: Stagnant non-agricultural employment
(per cent of working age population)



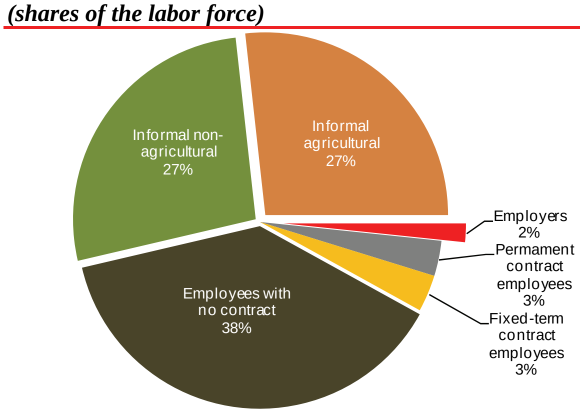
Sources: Sakernas and World Bank

The majority of the workforce have inferior jobs in the informal sector

Employment trends in Indonesia's labor market have been positive, albeit gradual, since 2003. Nevertheless, the workforce remains highly informal. In 2007, 24.1 percent of the active workforce was informally employed in service and industrial jobs, while another 37.2 percent worked informally in agriculture.

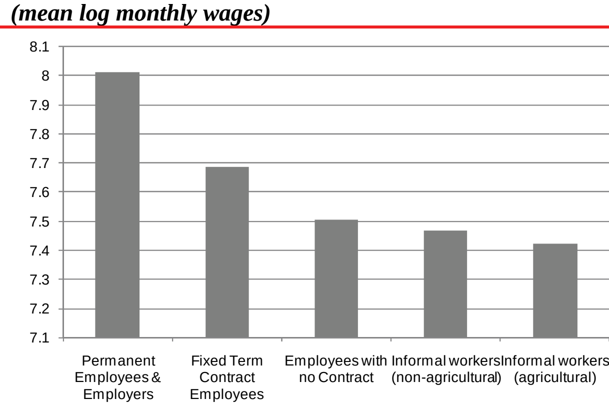
Some workers prefer the informal sector. Approximately one-quarter of informal workers earn more in this sector than they could expect to earn in a formal jobs. Most, however, would be better off in the formal sector. On average, workers in the informal sector earn 30 percent less than employees in the formal sector or employers. They do not benefit from non-wage benefits that formal sector workers expect, such as medical benefits or transportation and access to credit. Informal workers also report facing greater work stress than workers in the formal sector. Without accelerated job creation in the formal sector, most of these workers will remain in inferior informal jobs. Since informal workers tend to be poorer, stagnant formal employment growth will also slow-down the pace of poverty reduction in Indonesia.

Figure 47: Highly informal workforce
(shares of the labor force)



Source: Sakernas 2007 and World Bank

Figure 48: Formal sector employees earn more
(mean log monthly wages)



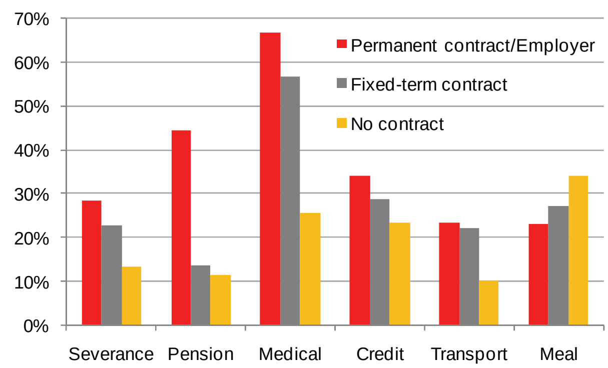
Source: IFLS 2007

But even in the formal sector, most employees are only slightly better off than informal workers

Jobs in the formal sector, however, are not necessarily better than those in the informal sector. 81 percent of employees in the formal sector work without a contract in place. On average, they earn approximately the same as agricultural or non-agricultural workers in the informal sectors. They are less likely to receive any of the non-wage benefits typically associated with formal sector employment, including severance pay, pension, credit and transportation benefits. For example, two-thirds of employees with permanent contracts and over one-half of workers with temporary contracts report receiving medical benefits.

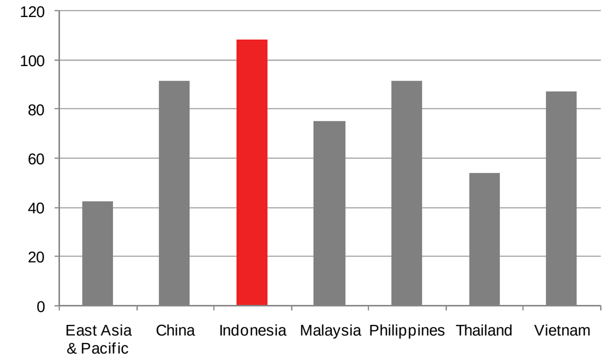
Only one-quarter of contract-less workers, in contrast, receive these benefits. When disputes arise with employers, non-contractual employees are also disadvantaged. Without job documentation to use as evidence they face barriers in accessing industrial relations courts.

Figure 49: Contract-less employees receive fewer non-wage benefits
(share of workers receiving benefit)



Source: IFLS 2007

Figure 50: Redundancy costs in Indonesia are the highest in the region
(severance costs in weeks of average earnings)



Sources: 'Doing Business' 2010

Debates continue on whether the pace of job creation could be accelerated.

The Manpower Law contributed to improvements in the creation of 'better' jobs by establishing a system to moderate minimum wages that, between 1999 and 2003, were rising rapidly. At the same time, the law significantly tightened hiring and firing regulations by restricting the use of temporary contracts and increasing severance rates. Since then, redundancy costs in Indonesia have continued to be the highest in the region. This has sparked an on-going controversy around the extent to which these regulations deter employers from hiring staff, and whether rigidities in the labor market are slowing the pace of job creation in the formal and non-agricultural sectors.

In a highly segmented workforce, policies must take the interests of the voiceless majority into account

In the current debate surrounding labor reform, workers groups have focused on improving workers' welfare through the enforcement of hiring and firing regulations. Workers with permanent or temporary contracts are concerned about improving worker protection. Informal workers, however, would benefit from policies that spur job creation in the formal and non-agricultural sectors, which would provide more opportunities for them to move into jobs with greater income security and benefits. Similarly, contract-less employees in the formal sector would benefit from policies that would encourage employers to employ more workers with permanent contracts. These workers, who represent the majority of the workforce, have little voice in shaping labor market policies that are negotiated in tripartite forums

…with the aim to expand opportunities for work in 'better' jobs

Job creation helps to share the benefits of growth more broadly, providing opportunities for the poor to earn their way out of poverty. In a segmented labor force like Indonesia's, however, job creation must focus on the creation of 'better' jobs in the preferred formal and non-agricultural sectors. The challenge faced by the new government, therefore, is to identify and support policies that encourage job creation to benefit the majority of workers seeking to find better jobs, while still ensuring adequate protection for formal sector workers. The World Bank's forthcoming *Indonesia Jobs Report*, expected for release in early 2010, will provide further ideas how labor policies and programs can encourage job creation and better prepare disadvantaged workers to succeed in the labor market.

4. Financing healthcare for Indonesia's growing labor force and aging population

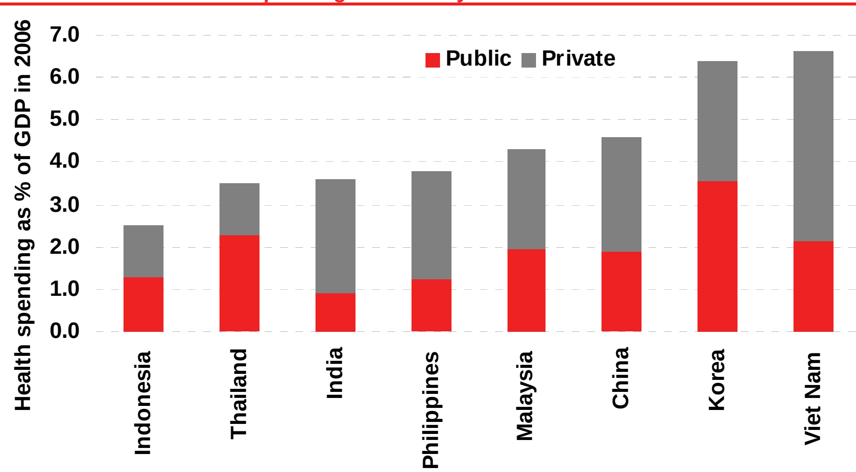
A commitment to universal health coverage but with many important details to be worked out

With the passage of Law 40/2004 on the National Social Security System (SJSN) in 2004, Indonesia became one of only a handful of developing economies committed to providing universal health insurance coverage for its entire population through a mandatory public health insurance scheme. The SJSN law calls for universal coverage by 2020. The details and the time-line for implementation of any move towards universal coverage have yet to be fully fleshed out. But it is clear, especially given the demographic trends highlighted above, that a move towards universal coverage is likely to result in substantial increases in the cost for health spending over the coming decade. And policy choices regarding how the reform will be financed, which groups should be subsidized by the government, what specific health benefits should be covered, what changes are needed in the service delivery system and how to pay those who provide the care, and a host of other regulatory and administrative issues will determine the financial sustainability of any initiative as well as the quality and extent of coverage and ultimately, the improvements in health outcomes enjoyed by Indonesia's population. A recently released World Bank report—*Health Financing in Indonesia: A Reform Road Map*—provides evidence and analyses meant to inform and assist the government as it develops and implements the move towards universal health insurance. This section provides a selective summary of the main messages of this report.

Over the last four decades, Indonesia has made major improvements in health outcomes…

Health outcomes have improved significantly since 1980 when life expectancy was only 52 years compared to almost 70 today, and some 100 infants out of every 1000 died before their first birthday, compared to less than 30 today. The total fertility rate has declined from 4.7 children per woman to slightly above 2. Despite these impressive improvements, Indonesia's achievements have been less impressive than some of its neighbors, and for certain health outcomes, such as maternal mortality, the country does not perform as well as other comparable income and health spending level countries.

Figure 51: Indonesia's health spending is relatively low



…and Indonesia's health delivery capacity has expanded significantly

Indonesia's health delivery system expanded significantly over the past 40 years. Virtually all Indonesian's have access to basic care through a network of 8000 Puskesmas and 22,200 Puskesmas Pembantu, and some 5,800 mobile health clinics. On the other hand, while Indonesia has far fewer hospital beds per capita compared to other comparable income countries, these beds are poorly utilized with occupancy rates on the order of 60 percent. In terms of human resources for health, while nurse mid-wives are readily available throughout the country, Indonesia's health workforce overall is small relative to other similar income countries and concerns over quality and efficiency persist. Its physician workforce is very small relative to comparators, and there are severe shortages of specialists, which are particularly problematic given the proposed expansions in health insurance coverage and the oncoming non-communicable disease burden.

From a cross-country perspective, Indonesia's health spending is relatively low

From a cross-country perspective, Indonesia's health spending is relatively low, but the country gets reasonable 'value for money' in terms of some health outcomes as well as relatively good financial protection. Indonesia spends only slightly more than 2 percent of its GDP on health, about half the level of other comparable income countries. Half of all health spending is public. About one-third of health spending comes directly from of out of pocket payments by households. Health is a relatively small share of the government's budget, some 5 percent, although the share has been increasing since the implementation of the Askeskin program in 2004. Despite low spending health outcomes and financial protection are relatively good, although these latter results may be due to Indonesia's relatively high education levels and extended family social structure.

Public health expenditures are playing an increasing important role…

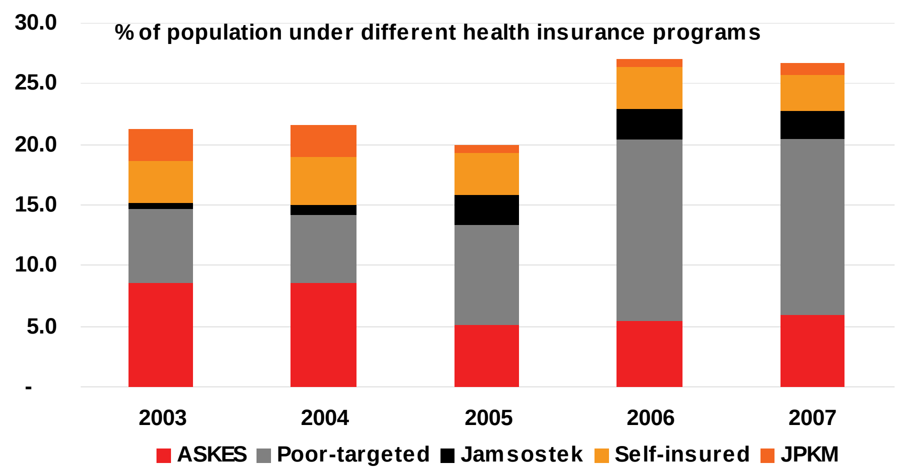
Private health expenditure has, historically, played a more important role than public health spending in terms of overall health financing in Indonesia. However, this trend started to change beginning in 2004 as the government introduced major health insurance programs targeted at the poor. It is expected that public health expenditure will have an increasingly important role to play in subsequent years as the government extends universal coverage to the entire Indonesian population. The establishment of Jamkesmas/Askeskin in 2004 has had an impact on both total health spending and the public share of spending. Out-of-pocket payments still comprise a sizeable share of health spending however, and the challenge for the government is to channel these expenditures into risk-pooling mechanisms in order to effectively provide protection against catastrophic health spending.

…and all of the major health insurance programs are publicly owned

Private Voluntary Health Insurance (PVHI) is not well developed in Indonesia. Each of the three major existing health financing programs is publicly owned and coverage levels, until recently have been low:

- Civil servants and their dependents are covered under the ASKES program, which is administered by a for-profit state enterprise, P.T Askes.
- Jamkesmas was originally designed to cover the poor but was expanded to also cover the near poor. It was originally administered by ASKES but in 2008 the Ministry of Health (MoH) took over most of the major administrative functions, including provider payment.
- Jamsostek is similar to a classic social insurance program for private sector employees in firms with 10 or more employees and is also administered by a for-profit state enterprise. Employers have the option to opt out, either by self-insuring or by purchasing private insurance for their employees. Both P.T. Askes and Jamsostek also sell private commercial policies.

Figure 52: Only about a third of Indonesia's population enjoys health insurance coverage



Sources: World Bank staff estimates from SUSENAS surveys.

There are two possible approaches to providing universal coverage

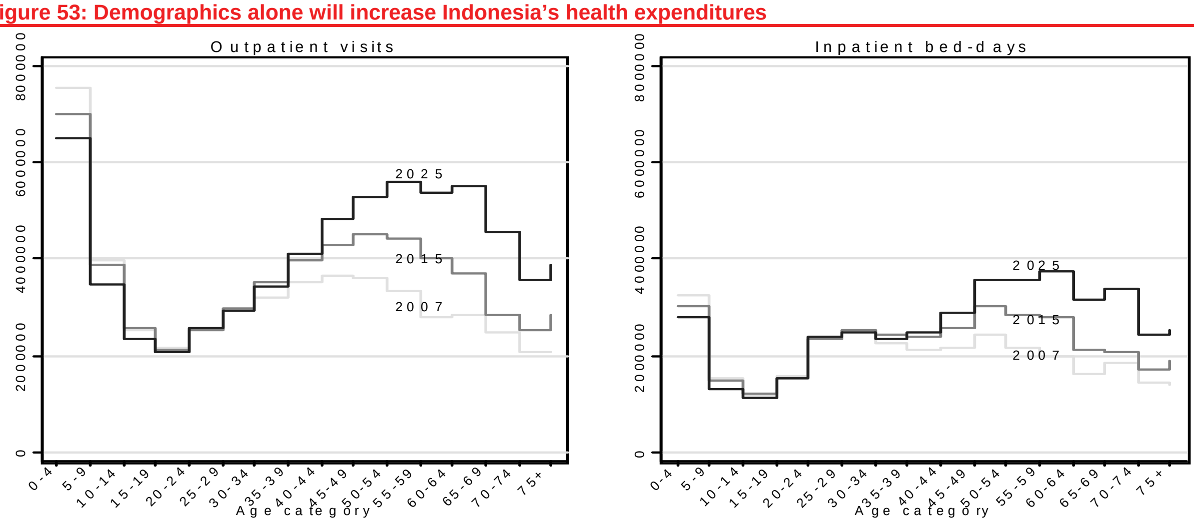
Given Indonesia's existing health financing programs, the current policy debate, and the 2004 Social Security Law, two main approaches to universal coverage seem viable. Both options would result in universal coverage, and both would have sufficiently large numbers of enrollees for effective risk pooling. Irrespective of the approach chosen, however, crucial decisions regarding the benefit package, cost-sharing, payment/contracting arrangements and modalities to address supply-side constraints need to be made. The three approaches are:

- A **national health service** fully financed by the government, similar to the national systems in Sri Lanka and Malaysia. This "Jamkesmas for all" would involve expanding the general revenue financed Jamkesmas program for the poor and near poor to cover the entire population.
- A **single national mandatory health insurance system** where the government subsidizes the poor and other disadvantaged groups, similar to the systems in Thailand and Turkey. This would approximate the 'new' national Social Health Insurance (SHI) model (now called Mandatory Health Insurance (MHI)), where the MHI system is funded through both wage-based contributions for public and private sector workers (and retirees) and government general revenue contributions for the poor and other disadvantaged groups.

Whichever approach is adopted, movement to universal coverage will have a sizeable impact on health spending

Clearly, whichever option is chosen, the movement to universal coverage will have a sizeable impact on Indonesia's health spending. Micro-analyses of current program costs and utilization patterns after the introduction of Askeskin/Jamkesmas allow crude projections of future costs. For example, crude estimates of future Jamkesmas costs range from 20 percent of current Jamkesmas spending to sixfold increases, depending on the coverage expansion scenario and health inflation assumptions chosen. Demographics alone are likely to substantially raise health expenditures over the next decade as the fraction of elderly in the population increases and the number of outpatient visits as well as inpatient bed-days

Figure 53: Demographics alone will increase Indonesia's health expenditures



Sources: Health Financing in Indonesia (World Bank, 2009)

Successful implementation of the move towards universal coverage will require carefully sequenced implementation of targeted, effective, and fiscally sound policies. The Social Security Council and the Ministry of Health have taken important first steps, but more is needed. The drafting of the 2010-2014 Medium-term Development Plan (RPJM), the Ministry of Health's own internal planning efforts in developing the next Renstra, and the potentially large and possibly unaffordable expenditure implications of expanding health insurance to some 76 million poor and near poor, make this an ideal time to refocus efforts on the comprehensive set of policies needed to effectively implement universal health coverage in the next decade.

Investing in Indonesia's Institutions
for Inclusive and Sustainable Development